Regulatory interpretation: a case study of the FSA policy of rule-use
Georgosouli, Andromachi

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REGULATORY INTERPRETATION: A CASE STUDY OF THE FSA POLICY OF RULE-USE

PhD Thesis 2008

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I declare that the work presented in this thesis is my own.

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ABSTRACT

My doctoral thesis examines the policy of rule-use in the UK financial regulation. Its case study is the current FSA conduct of business regulation. It consists of two parts. Part I considers the evolution of the policy of rule-use during the past twenty years of financial regulation and up to the end of 2006. It argues that it has been transformed from a rule-centric regime into an interpretation centric-regime, where emphasis is placed on the interpretive project that makes possible the use of regulatory requirements rather than the production of self-contained and static rules. Part II explores the grounds of this policy development by looking into the nature of regulatory interpretation. With this regard, it discusses two alternative theoretical accounts of regulatory interpretation: the communicative thesis, which emanates from Julia Black’s study of the use of rules in financial regulation under the Financial Services Act 1986; and the constructive thesis, which draws on Ronald Dworkin’s writings on the idea of law as integrity. The communicative thesis regards regulatory interpretation as a form of communication that is bound to fail and justifies the interpretation-centric approach as a tactic that aims to prevent or remedy failure of communication. The constructive thesis views regulatory interpretation as a dialectical practice that requires the participants of the wider regulatory community to work out the public standards (“principles”) that govern their interrelations and explains the interpretive shift in the policy of rule-use as an attempt to meet the demand for new and better interpretations. The thesis concludes that the constructive thesis is preferable, because it is better able to accommodate two fundamental intuitions about the practice of interpretation; the intuition that the
resolution of regulatory interpretive disputes must be the outcome of a genuine and reciprocal commitment to a public conception of justice and the intuition that scarce public resources should be wisely administered rather than wasted.
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INTRODUCTION

Legal rules are widely employed as means for social organisation and control.1 They distribute jurisdictional competences; they guide and control behaviour; they determine acceptable and unacceptable modes of conduct; they convey expectations and, over time, shape attitudes and change public perceptions. As a social practice, the use of rules has three dimensions: rule-formation, rule-application (or rule-following) and rule-enforcement. A perpetual interpretive process underlies these dimensions.2 The regulator cannot perform its rule-making function unless it interprets in some way a set of fundamental policy objectives. Similarly, it cannot supervise and encourage compliance with the rules or decide what should be the most appropriate mode of enforcement in light of the idiosyncratic features of each particular case, unless it makes a more refined interpretation of its regulatory requirements. By the same token, the regulated population cannot comply with regulatory prescriptions unless they interpret them. Ultimately, interpretation is an indispensable aspect of rule-use, for it is through interpretation that the meaning of rules is clarified, disputes about how rules

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1 By legal rules I have in mind both legally enforceable and non-legally enforceable regulatory requirements as, for example, guidance and codes of practice. Someone might object that non-legally binding regulatory requirements are not really ‘legal rules’ for they are not legally enforceable. Although, I cannot pursue this claim further, for the purposes of this thesis, it is appropriate to treat all types of regulatory requirements (legally enforceable and non-legally enforceable) as ‘legal rules’ in order to connotate that the presence of legally and non-legally enforceable regulatory requirements does not suggest the existence of a social domain that stands outside the reign of the Rule of Law. It simply signifies the expediency and economy of avoiding enforcement by bringing a legal action in front of the courts, where compliance can be achieved with less radical and more informal means. What is important is that the power of the regulatory authority to promulgate legal rules and put them into practice is always licensed by the Rule of Law either by virtue of a statutory instrument (e.g. the FSMA 2000 or the FSA 1986 as the case may be) duly passed by the Parliament or ad hoc to the extent in which the judiciary acknowledges this practice as lawful. P Craig, Administrative Law (5th edition, 2003), ch. 16, 398-400 and 810-812; and S. Arrowsmith, 'Judicial Review and the Contractual Powers of Public Authorities', 106 Law Quarterly Review (1990), 277. Recent case law that expanded the scope of application of judicial review seems to lend support to my claim. See, for example, R v Panel on Takeovers and Mergers ex p Datafin plc [1987] QB, 152; R v Advertising Standards Authority ex p The Insurance Services plc, [1990] COD 42; and Bank of Scotland v Investment Management Regulatory Organisation Ltd, [1989] SLT, 432.

2 Talcott Parsons observes that the “interpretive function may be said to be the central function of the legal system.” W. Twinning and D. Miers, How to Do Things With Rules (1982), 165 and 170-172.
should be understood are resolved and their scope of application and consequences are crystallised.

Given the crucial role of legal rules in public administration it is not a surprise why in recent years a special field of policy making appears to have emerged with respect to the effective use of rules.\(^3\) The policy of rule-use has as its subject matter the formation, application and enforcement of rules and, in a more abstract level, it underlies a two-phase interpretive project through which public policy objectives (occasionally specified by statute) are first translated into more concrete regulatory stipulations and then put into practice in the more refined form of regulatory requirements that are tailor made to the idiosyncratic features of its particular case.\(^4\)

This doctoral thesis examines the policy of rule-use in UK financial regulation.\(^5\) It takes the current FSA conduct of business regulation as a case study to engage with broader questions about the nature of rules, the nature of regulatory interpretation\(^6\) and how the Rule of Law shapes our understanding of the policy choices underlying the use of rules in public administration. It considers two questions: First, how did the policy of rule-use evolve during the past twenty years? And second, how should we account for this development in regulatory policy? The thesis argues that in

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\(^3\) Arguably, the use of rules has emerged only recently as a conscious policy concern. FSA, ‘Designing the FSA Handbook of Rules and Guidance’, FSA Consultation Paper No.8 (April, 1998); and D. Walker, ‘The New Settlement in Financial Services’, Law Society’s Guardian Gazette (July, 1989). See also below Chapters Two and Three.  


\(^5\) The term ‘(financial) regulation’ refers to the body of legal rules, regulations and administrative requirements established by public authorities or self-regulatory bodies as well as to its application and enforcement. For a similar use of this term see G. A. Walker, International Banking Regulation: Law, Policy and Practice (2001), 1. As a political phenomenon, ‘regulation’ is difficult to define and notoriously contested. Nevertheless, several leading commentators agree that broadly speaking ‘regulation’ connotes any control system, which has at least the following three components: (a) the capacity of standard setting, (b) the capacity of information gathering and (c) the capacity of behaviour modifying. A. Ogus, Regulation: Legal Form and Economic Theory (2004); C. Hood, H. Rothstein and R. Baldwin, The Government of Risk (2001); and B. Morgan and K. Yeung, An Introduction to Law and Regulation (2007), ch.1.  

\(^6\) The term ‘regulatory interpretation’ refers to the interpretive practice that makes possible the use of rules in the regulatory system.
the past two decades there has been a clear shift towards the implementation of an interpretation-centric (as opposed to rule-centric) policy of rule-use. It then proposes that this policy development can be better explained as an attempt to facilitate the wider regulatory community in meeting the demand for new and better interpretations by duly identifying and remedying interpretive mistakes before and where possible in preclusion of judicial interference (the constructive thesis), rather than as a response to failure of communication between the regulator and the regulated population (the communicative thesis).

The thesis is divided into two parts. Part I (Chapters One to Three) examines the various stages of evolution of the policy of rule-use from the early 80’s until the end of 2006. To this end it makes extensive reference to the legal instruments that comprise the legal framework of the UK financial regulation in general and conduct of business rules in particular as well as to the relevant preparatory work and literature commentary. Chapter One, which concerns the case study of the thesis, overviews the FSA conduct of business regime. Chapter Two explores the policy of rule-use under the regulatory regime that was established by the Financial Services Act 1986

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7 Rule-centric regimes identify with policies that perceive the effectiveness of rules as predominantly a function of the rules themselves. Therefore, their focus is on the production of self-contained and static regulatory norms. These regimes are associated with command and control regulation or more generally with regulatory settings that are vertical, legalistic and prescriptive in character rather than horizontal open and participatory in nature. Ascribing meaning to regulatory requirements is not regarded as a common interpretive project. The exercise of interpretive discretion is tightly controlled and the outcome of interpretive-decision making is dictated. Deliberation by way of self-regulatory configurations may be a feature of the regulatory system. Nonetheless its nature is symbolic rather than substantive not least because self-regulation is never fully operationalised. The interpretation-centric regimes differ in that they regard rule effectiveness as mainly a function of their interpretation. Therefore regulatory officials place emphasis on the regulation of interpretive process that makes possible the formation application and enforcement of rules rather than their design. They are associated with meta-regulation and market-based regulatory settings that are substantially open, participatory and discursive in nature and whose implementation involves the decentralisation of interpretive decision-making. Significantly, under an interpretation-centric regime, regulatory interpretation is treated as a common dialectical process, which is administered but never curtailed by the regulator. In practice, approaches to the use of rules may not be ‘purely’ rule-centric or interpretation centric. This distinction, however, remains useful not least because it offers a more comprehensive theoretical framework for the study of the interaction of the policy of rule-use with other regulatory policies (e.g. enforcement) and for making sense of the parameters of success or failure of the various regimes.
(“self-regulation under a statutory framework”). Chapter Three continues the examination of the policy of rule-use this time after the introduction of the Financial Services and Markets Act 2000 and the official launch of the Financial Services Authority as a single mega-regulator for the financial markets in the UK. Part I concludes that by the middle of 90’s there has been a clear shift towards an interpretation-centric approach to the use of rules, whose prime objective has been the control and management of the interpretive project that makes possible the use of rules, rather than the production of self-contained and static regulatory requirements.

Part II (Chapters Four to Six), considers the grounds of this policy development drawing on the nature of regulatory interpretation. It advances the communicative thesis and the constructive thesis of regulatory interpretation. Specifically, Chapter Four makes reference to Rules and Regulators -where Julia Black studies the nature and use of rules in financial regulation- with the view of proposing a communicative account of regulatory interpretation, according to which regulatory interpretation should be seen as a form of communication between the regulator and the regulated population, that is prone to failure due to information asymmetries and interpretive divergence.\textsuperscript{8} Chapter Five resorts to a comparative analysis of the practice of interpretation in law and in literature. Its aim is to bring to the surface some difficulties that are associated with the communicative thesis and to open the way to an alternative theoretical account of regulatory interpretation – the constructive thesis. The latter envisages regulatory interpretation as an occasion for the regulatory community to resolve interpretive disputes by working out the public standards that govern their relationships. The communicative thesis and its constructive counter-part offer two alternative accounts of the grounds for the interpretive shift in the policy of rule-use.

\textsuperscript{8} J. Black, Rules and Regulators (1997).
Whereas the former justifies the interpretation-centric approach to the policy of rule-use as a tactic that aims to prevent or remedy failure of communication, the latter explains this development as an attempt to enable the regulatory community to meet the demand for new and better interpretations where possible in preclusion of judicial interference. Chapter Six develops further the idea of a constructive reading of regulatory interpretation by defending it against certain objections. To this end it brings together insights from the work of Donald Davidson and the work of Ronald Dworkin on the idea of law as integrity. It suggests that the constructive thesis is preferable to the communicative thesis because it is better able to accommodate two fundamental intuitions about the practice of interpretation. First, the intuition that the resolution of interpretive disputes in the regulatory context must be the outcome of a genuine and reciprocal commitment to a public conception of justice, rather than the product of arbitrary and unprincipled negotiated trade-offs. Second, the intuition that procedural efficiency matters in that the dialectical practice of regulatory interpretation must not be conducted by using inefficient methods. Finally, the Conclusion brings together the main threads of my argument and sets out an agenda for future research.

Why focus on the policy of rule-use? To start with, there is good reason to think that the timing is ‘right’. Nearly ten years after the Labour’s Government reform of financial regulation it is about time to reflect on the changes that it brought about. This is even more so with respect to the use of rules, as the Authority’s policy choices have been constantly challenged after a series of events older and new as, for example, the industry’s persistent reservations to a principled-based approach to regulation, the progressive centralisation of regulatory decision-making in EU level and the recently shaken relationship between FSA and the Bank of England as a
result of the perceived regulatory failure to guard the UK market against the sub-prime crisis in the UK and adequately deal with the collapse of Northern Rock.⁹

In practical level, the first and most obvious reason justifying one’s interest with this topic is that the policy of rule-use shapes the ways in which the four statutory objectives of the Financial Services Authority (FSA) -namely market confidence, public awareness, consumer protection and reduction of financial crime- are translated into regulatory practice. Ultimately, FSA’s capacity to attain these objectives depends on the success or failure of its policy of rule-use. Furthermore, the policy of rule-use constitutes a crossroads where other policy trends meet and interact. For example, while the principles-based architecture of the FSA Handbook manifests a purposive approach to the application and enforcement of rules, the fostering of communicative elements is intended to bring the whole idea into practice.¹⁰ In this connection it pays to consider the nature of this interaction and how the ensuing dynamic between purposiveness and conversational regulation affects regulatory performance and determines the ways in which the regulatory Authority interacts with other institutions – notably the judiciary. A third reason is that although there is a growing

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¹⁰ The principles-based approach to regulation, the purposive approach to the application and enforcement of rules as well as other terms such as conversational regulation and meta-regulation, all are discussed in the relevant chapters.
literature assessing the advantages and disadvantages of some recent trends in financial regulation such as fostering the discursive and participatory character of regulation, the shift towards meta-regulation, and the adoption of a risk-based approach to regulation, a systematic study of the extent to which the present regime differs from its predecessor is still underdeveloped. Finally, it should be noted that there are very few comprehensive studies of the practice of interpretation in the context of regulation. Indeed, writings that are exclusively devoted to regulatory interpretation are rudimentary when compared with writings about other aspects of the use of rules in public administration.\(^{11}\) It is argued that this is regrettable. The examination of regulatory interpretation has the potential to advance our understanding on a number of issues such as the concept of rule-effectiveness and its institutional implications\(^{12}\) or the question of the susceptibility of legal rules to true or false interpretation—an issue that is inextricably interwoven with our quest for authority and boundaries in the interpretation of rules in the regulatory context. The present thesis makes an attempt to fill in this gap.

The thesis is built upon four inter-related assumptions. The first is that in financial regulation the use of rule comprises a separate branch of policy making which borrows from a range of other policies including those of rule-making, compliance, enforcement and accountability.\(^{13}\) The second one is that—despite its peculiarities—regulatory interpretation is a species of legal interpretation and therefore it is bound by the political history of the institution of law. The third assumption is that the use of rules is a two-

\(^{11}\) For instance, the optimal design of rules, the inter-relation between rules and their enforcement, the problem of abiding by the letter rather than spirit of rules, the phenomenon of rent-seeking in the course of rule formation, application and enforcement of rules etc. See also note 24 below.

\(^{12}\) For example, in relation to rule-effectiveness, is ‘getting the interpretation of rules right’ one of the parameters for regulatory effectiveness? If yes, what should be the criterion of correctness? What institutional arrangements guarantee that rules receive correct interpretation and that mistakes are appropriately remedied?

\(^{13}\) Above note 3.
phase interpretive project in the course of which policy objectives take the form of concrete regulatory requirements and then are translated into more specific regulatory directives that are tailor-made to the idiosyncratic circumstances of each particular case. Whereas rule-formation falls within the first phase, rule-application and enforcement fall within the second phase. Finally, the fourth supposition is that the regulatory authority, the regulated population and virtually any other interest-group that is likely to be affected by regulation (notably, consumers) constitute a regulatory community whose members are involved in the interpretive project in various modes and intensity depending on a number of factors including their institutional role and the context of the interpretive dispute (rule-formation, rule-application, rule-enforcement). These four postulates are further supplemented with a range of other suppositions, reference to which is made in the relevant chapters.

The methodology of the thesis is partly descriptive, partly theoretical and partly interdisciplinary. In Part I, the analysis of the rationale for investor protection and conduct of business regulation is based on an overview of the economic literature on this topic, whereas the exploration of the policy development with respect to the use of rules in financial regulation draws on a critical analysis of primary and secondary resources on the evolution of conduct of business regulation in the UK spanning from the middle 80’s until the end of 2006. In Part II the discussion starts from a brief overview of the main theoretical postulates that underlie Julia Black’s work on the nature and use of rules in financial regulation and progressively embarks upon an intellectual journey in search of the nature of regulatory interpretation through a comparative analysis of the practice of interpretation in law and interpretation in literature as well as a critical appraisal of Stanley Fish’s contextualism in light of Ronald Dworkin’s
theory of law as integrity and Donald Davidson’s writings on the Principles of Coherence and Charity in interpretation.  

The literature on the use of rules in public administration is vast and diverse. Some of the themes that have attracted special attention are (a) the nature of rules, (b) the susceptibility of rules to meaning (c) the relationship between rules and context, (d) the function of rules as instruments of social organisation and control and (e) the dimensional analysis.

All these are extensively discussed in Part II.

The views of Herbert Hart and Ronald Dworkin are of particular interest in this respect. According to Hart legal rules are entrenched authoritative statements, which are meant to guide behaviour, be applied on an indefinite number of occasions and have sanctions attached for their breach (H. L. A. Hart, The Concept of Law (1994) chs 5 and 6). According to Dworkin the crucial difference between rules and principles is that rules function in “all-or-nothing” manner. If two rules are in conflict, one of them must be invalid or stands as an exception to the other. By contrast, principles have the quality of weight or importance. If two principles are in conflict then the decision maker must consider the relative weight of each. R. Dworkin, Taking Rights Seriously (1977), ch. 2; and The Philosophy of Law (1977), 47. A third definition –this time of the term ‘rule’ in general- has been suggested by William Twinning and David Miers (How to Do Things with Rules (2nd edition), 127) and further adopted by Robert Baldwin in ‘Why Rules Don’t Work’ (53 Modern Law Review, (1990), 321) where the term ‘rule’ refers to norms guiding conduct or action in a given type of situation.

In this connection the views range from radical indeterminacy (e.g., S. Levinson, ‘Law as Literature’ 60 Texas Law Review (1982), 373; and J. W. Singer ‘The Player and the Cards: Nihilism and Legal Theory’, 94 Yale Law Journal (1984)) to moderate forms of indeterminacy (e.g., G. Graff, “Drop Off Dead” “Keep Off the Grass” and Other Indeterminacies: A Response to Stanford Levinson’, 60 Texas Law Review (1980), 405); and firm rejections of indeterminacy (e.g., O. Fiss, ‘Objectivity and Interpretation’, 34 Stanford Law Review (1982), 739).

See notably S. Fish Is There a Text in the Class (1980) and Doing What Comes Naturally: Change, Rhetoric and the Practice of Theory in Literary and Legal Studies (1989) and D. Davidson, Subjective Intersubjective Objective (2001). See further, Part II of this thesis.

I. Ayres and J. Braithwaite, ‘Responsive Regulation’ (1992) (The authors consider the debate on regulation and deregulation. They argue for a regulatory approach that is responsive to the structure of the regulated industry and combines techniques of persuasion and sanction); A. Ogus, Regulation: Legal Form and Economic Theory (1994) (The author resorts to the postulates of the law and economics school of thought to assess the appropriateness of various regulatory instruments including legal rules). T. Daintith, ‘The Techniques of Government’ in J. Jowell and D. Oliver (eds), The Changing Constitution (1994), ch.8 (The author explores the function and effectiveness of command-based regulatory tools and economic means of regulation as, for example, taxes and subsidies, which are expected to enhance competition); E. Bardach and R. Kagan, Going by the Book: The Problem of Regulatory Unreasonableness (1982) (The authors examine the causes and consequences of “regulatory unreasonableness”—the practice of enforcing rules in a mechanical and legalistic manner- and they argue for a “flexible approach” to regulation which entails regulatory strategies that rely less on direct governmental prescriptions); F. Schauer, Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life (1991) (The author argues against the conventional view, which posits that rules do little due to the problems of over- and under- inclusiveness, on the grounds that it fails to distinguish between those who articulate rules and those who apply them); W. Twining and D. Miers, How to Do Things with Rules (2nd edition) (the authors aim to provide a systematic account of the practices of interpretation and application that constitute a basic aspect of “rule-handling” by placing emphasis on the influence of standpoint and role on the meaning of rules); and R. Baldwin, Rules and Government (1995) (The author offers a comprehensive examination of the use of rules as tools of government and he is particularly concerned with issues of legitimacy).

According to Baldwin rules have four dimensions: (a) specificity or precision; (b) inclusiveness; (c) accessibility and intelligibility and (d) status or force. According to Diver, rules have three dimensions (a)
relationship between administrative discretion, adjudication, enforcement and accountability;\(^{20}\) (f) the economics of rule-making, compliance and enforcement.\(^{21}\) Similarly, it is not the first time where the use of rules in the specific context of financial regulation becomes the subject of research. Julia Black was the first to study this topic about ten years ago and in relation to the system of regulation that was introduced by the Financial Services Act 1986.\(^{22}\) A wealth of ideas such as the presence of interpretive communities


\(^{22}\) The Financial Services Act 1986 was subsequently replaced by the Financial Services and Markets Act 2000. See also Chapter Three below.
in the regulatory arena and the putting into practice of a conversational style of regulation (just to mention a few) are attributed to her.\textsuperscript{23}

My thesis draws on these earlier writings and in some sense continues the work that has been done already in relation to the use of rules in financial regulation. However, it differs from the mainstream literature in various respects. One of the most noticeable points of departure concerns the treatment of the subject matter under examination. In this thesis, the attempt is made to approach the use of rules as a distinct field of policy development and not as a matter incidentally discussed in the context of other branches of policy making such as compliance, enforcement and accountability.\textsuperscript{24} In addition, the thesis seeks to account for certain policy trends by examining the nature of regulatory interpretation instead of focusing on the rules per se and conducting dimensional analysis, or by relying on the economics of rule-making, compliance and enforcement.

Furthermore Part II of my thesis, which explores the nature of interpretation in regulation, is premised on Dworkin’s famous distinction between “conversational” and “constructive accounts” of interpretation in law and adjudication.\textsuperscript{25} It should be noted however, that here the term “communicative” is used in place of “conversational” for mainly two reasons: The first one is the prevention of any confusion with Black’s work in regulatory literature regarding “regulatory conversations” and the

\begin{flushright}
\footnotesize\textsuperscript{23}Her work is extensively discussed in Chapter Four.
\footnotesuperscript{24}\textit{How to Do Things With Rules} by W. Twining and D. Miers seems to be one of the rare exceptions. Still, it should be noted that the authors are not concerned with the nature of regulatory interpretation but with the practice of interpretation and application as aspects of “rule-handling.” See also above note 11.
\footnotesuperscript{25}To be precise, Ronald Dworkin propounds three different kinds of interpretation; “conversational”, “constructive”, and “scientific interpretation.” “Scientific interpretation” does not qualify as a candidate theory of regulatory interpretation because it is causal rather than purposive in nature. Here the term “communicative” is used in place of “conversational” as more appropriate for capturing the idea that in the public domain taking part in a conversation always serves some purpose like the provision of clarification, the resolution of disputes the promotion of social order or cooperation. R. Dworkin, \textit{Law's Empire} (2000), 49-53.
\end{flushright}
adoption of a “conversational model of regulation”. The second reason is that the term “communicative” as an attribute to one of the two theoretical accounts of regulatory interpretation here advanced was thought to be more appropriate as better able to convey the intuition that—contrary to private contexts— in the public domain conversations are always conducted for some purpose as, for example, making sense of controversial regulatory provisions, resolving disputes, keeping social order and promoting the coordination of a joint project.

In any rate, to the extent in which this analysis borrows from Dworkinian jurisprudence, it differs from earlier writings in that it is not based on legal positivism and the critical legal studies movement, which have dominated the intellectual landscape. This signals a departure from mainstream thought given that one of the consequences of the Dworkinian affiliation of this thesis is that it propounds the idea that our stance towards policy developments in the regulatory context and more generally in the public domain should be informed by a substantive theory of justice. In this manner, this thesis aspires to contribute to the relevant literature in the

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26 Some of the main postulates of the critical-legal studies school of thought are the idea that the law is mere politics serving the interests of the powerful and preserving the dominant ideology of the time and the idea that law is fundamentally indeterminate. Proponents of the critical legal studies school of thought include Duncan Kennedy, Mark Tashnet and Roberto Unger. Legal positivism is the view that the existence and the content of law depend on social facts and not on its merits. This is not to say that the merits of a legal system are not important to the philosophy of law. They are important but they do not determine whether law or a legal system exists. Accordingly, legal positivism is the doctrine that focuses on the institutional aspects of law and treats law as a social construction. Some of the most prominent legal positivists of recent times are Herbert Hart, Hans Kelsen, Joseph Raz, and Jules Coleman. A look at the literature leaves little doubt of the impact of these suppositions on mainstream scholarly thought. On the critical legal studies movement see, C. Sypnowich, ‘Law and Ideology’ in Stanford Encyclopedia of Philosophy (2001), available at www.plato.stanford.edu/entries/law-ideology. On legal positivism see L. Green, ‘Legal Positivism’ in Stanford Encyclopedia of Philosophy (2003), available at www.plato.stanford.edu/entries/legal-positivism.

27 This view is clearly at odds with current orthodoxy. For example, R. Baldwin argues that our inquiry into the legitimacy of rules in public administration should not be based on a generalised theory of democracy because it is difficult to come up with a non-controversial theory to which the legitimacy claims appeal. Furthermore, he posits that trade-offs among competing policy objectives should not be grounded on a purely “personal vision of the ideal of democratic legitimacy” but only on “anticipated reactions to the legitimacy of the process based on competing legitimacy claims of others”. Rules and Government (1995), 58; and T. Prosser, ‘Book Review: Rules and Government by Robert Baldwin,’ 59 Modern Law Review (1996), 762.
following two ways: By offering an up to date analysis of the policy of rule-use in the UK financial regulation and by exploring how the jurisprudence of Ronald Dworkin could enrich our understanding of the workings of regulatory interpretation and even challenge the current orthodoxy that perseveres contemporary studies of the use of rules in public administration.

Moreover, a special note should be made about the relationship between the communicative thesis of regulatory interpretation that is here advanced and Black’s conversational account of regulation. Similarly to Black’s theory, the communicative thesis pays attention to the discursive aspect of the process of regulation. It differs however in terms of subject matter, aim and theoretical foundation. Contrary to Black’s theory, the communicative thesis is not a general theory of regulation. It is only a theoretical account of the nature of interpretation in regulatory settings and considers issues that are specific to the nature of interpretation as, for example, the possibility of right answers to questions of interpretation and the source of authority. Furthermore it is not framed on discourse analysis and legal positivism. Its theoretical foundation lies with Dworkinian jurisprudence.

Finally, a brief note on what this thesis does not claim to be. This study does not intend to offer a systematic critical overview of the literature on the policy of rule-use (making special reference to *Rules and Regulators*) administrative discretion and control, optimal design of rules and enforcement. In addition, it is not concerned with recent case law dealing with the jurisdictional competences of administrative agencies vis a vis the judiciary. Similarly, it is not its purpose to assess the FSA conduct of business regulation in terms of substantive requirements -for instance, the effectiveness of Chinese Walls as a method for managing conflicts of interest, or the problems of definition and enforcement associated with best
execution. Furthermore, this thesis does not aim either to offer a systematic
critique of Professor Hart’s legal positivism or to defend Dworkin’s
jurisprudence. By the same token a comprehensive examination of the law
as interpretation movement falls beyond the scope of this analysis and so it
does a full exploration of the perceived merits and difficulties associated
with Stanley Fish’s contextualism. Finally, this thesis does not claim to be a
treatise on the idea of objectivity in law and interpretation. Rather, it draws
on various strands of thought and disciplines in so far as this would befit a
study of the evolution of the policy of rule-use in financial regulation and
the grounds underlying its transformation into an interpretation-centric
regime.
PART I - THE POLICY OF RULE-USE IN THE UK
FINANCIAL REGULATION
CHAPTER ONE

The Case Study

1. Introduction

This chapter considers the case study of this thesis. It examines that branch of financial regulation, which governs the provision of financial services and products in the retail sector.\(^1\) Conduct of business rules (COB) stand at the centre of this regime.\(^2\) They are built around the FSMA 2000 authorisation and financial promotion regime.\(^3\) They are part of the FSA Conduct of Business Sourcebook\(^4\) and comprise regulatory requirements whose principal aim is to provide investor protection.\(^5\) COB rules govern a variety of issues including client classification, financial promotion, information...

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[^4]: The FSA Conduct of Business Sourcebook (COB Sourcebook) originates from the Conduct of Business Rulebook of the Securities and Investment Board (SIB) and the Conduct of Business Rulebooks of the various Self-Regulatory Organisations (SROs). B. Rider, C. Abrams and E. Ferran, *A Guide to the Financial Services Act* 1986 (second edition), ch.6. On the November the 1st, 2007, the Conduct of Business Sourcebook will be replaced by a new one –the NewCoB Sourcebook (also referred to as “COBS”) - as a result of the UK implementation of the Markets in Financial Instruments Directive. I will return to this point in various occasions below.

[^5]: Consumer protection figures among the statutory objectives that the Financial Services Authority (FSA) is bound to pursue. Alongside consumer protection, the FSA is entrusted with the promotion of market confidence, public awareness and the reduction of financial crime. See FSMA 2000, ss.3-6.
disclosure, unfair practices, suitability of advice and best execution. Below I discuss the economic rationale for conduct of business regulation and review the core conduct of business rules. The discussion would remain incomplete if no reference was made to the implementation of the Markets in Financial Instruments Directive (MiFID) in the UK and the launch of the new Conduct of Business Sourcebook (NEWCOB) by November 2007. Thus, towards the end of this chapter I offer an epigrammatic overview of this significant piece of EU legislation and explain how it will affect the UK conduct of business regime in terms of substance, by considering briefly key points of departure from the existing regime.

2. Arguments for and against the economic rationale for conduct of business regulation

2.1. The scope of the debate

Before moving on, it is essential to make a clarification about the scope of the economic rationale for (financial) regulation. When we reflect on the economic grounds that may justify the State's intervention in economic life, we need a conception of the economic rationale that captures the spectrum of all possible factors that have an impact on the costs of regulation. One option is to draw on the work of David Llewellyn and his influential paper prepared for the Financial Services Authority, where he propounds a narrow definition of the economic rationale for financial regulation. Llewellyn

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6 Broadly speaking, investor protection is pursued by a plethora of requirements including, disclosure of information, licensing and authorisation, market structure, solvency and liquidity requirements. Consequently, it involves the application of a much wider array of regulatory requirements than rules regulating conduct of business. A. Page and R. Ferguson, *Investor Protection* (1992), chs.4 and 5.


8 Changes in relation to rule-design and the overall policy of rule-use will be examined in Chapter Three.
argues that the economic rationale for regulation (why it might be justified on economic criteria) must be distinguished from the reasons for regulation (why in practice regulation may be imposed), and the objectives of regulation (the aims, that a particular regulatory regime seeks to achieve). Though plausible, this distinction does not seem workable for our purposes because it falls short from offering a comprehensive account of all cost-determinants of financial regulation. Let me illustrate this by the following example. Instances of regulatory capture boost the cost of regulation and, therefore, -common sense suggests- we should take them into account when we are assessing the desirability of financial regulation. If we were to follow Llewellyn, however, we would have to exclude them from consideration, on the feeble ground that regulatory capture provides an explanation of why regulation may be imposed in practice –not a justification of regulation on economic criteria.

To remedy this flaw, in the subsequent sections, I adopt a broader definition.

2.2. Arguments for the economic rationale for investor protection

2.2.1. Introduction

As David Llewellyn points out, an investment contract may go wrong for one of the following reasons:

“(i) the consumer receives bad advice –perhaps because an agency conflict is exploited;
(ii) the supplying institution becomes insolvent before the contract matures;
(iii) the contract turns out to be different from what the consumer was anticipating;

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10 Above, 12.
(iv) fraud and misrepresentation; and
(v) the financial institution has been incompetent.”

What are the causes of these problems? Is conduct of business regulation eligible to control these causes and reduce the probability of them occurring in an economically efficient manner? Below I discuss some of the main arguments that are set forth by those commentators that answer these questions in the affirmative.

2.2.2. Informational problems and qualitative uncertainty

Arguably, the ultimate rationale for the state’s concern to protect retail investors is the correction of market failures and imperfections. In the retail financial sector the peculiar features of long-term investment contracts and the “principal-agent” problem inherent in the fiduciary relationship between the financial intermediary and its client mould the phenomenology of market imperfections and failures into what economists describe as the problem of “uncertainty about the quality of the products and services”. Its first component refers to the inability of consumers to distinguish good quality from bad quality products. Its second component describe consumer inability to assess the quality of services provided, the latter being advice, asset management etc. and is closely related to the question of suitability of the products and/or services offered.

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11 Above n. 9, 21-23; and D. Llewellyn, ‘Regulation of Retail Investment Services’, 15(2), Economic Affairs, (Spring 1995), 12-17 at 13.
12 The problem of economic agency is discussed in a separate subheading below.
13 Informational asymmetries lie in the heart of this problem. S. Collins and J. Black, Cranston’s Consumers and the Law, (2000), 30-4. They mainly take the following two forms: (a) inequalities in the capacity to have access and evaluate information and; (b) under-production of information. Above note 6, 36-38. Informational problems are due to the fact that information is a “public good”. Yet, precisely because it is a “public good” not all consumers need to be perfectly informed. See, I. D. C. Ramsey, Rationales for Intervention in the Consumers Marketplace (1984), 26-28; On the impossibility of informational efficient markets see, S. J. Grossman and J. E. Stiglitz, ‘On the Impossibility of Informational Efficient Markets’, 52 American Economic Review (1980), 393.
2.2.3. Consumer inability to make informed choices and the peculiar characteristics of the investment contract

Empirical evidence suggests that consumers are financially illiterate to an alarming degree.\(^{15}\) Lack of information owes partly to the fact that they do not have equal access to sources of information and partly because they are incapable to adequately evaluate available information.\(^{16}\) At the same time, consumers tend to under invest in the acquisition of information due to free riding problems and the costs of research. These circumstances leave hardly any scope for consumers to transact in a manner that would promote the efficient allocation of resources.

The peculiar characteristics of investment contracts exacerbate this problem.\(^{17}\) Their complex and technical nature and their prolonged duration bear out a multitude of problems for consumers including difficulties in gaining experience of the quality of the financial product through frequent purchase and great reliance on the advice, guidance and professional skills of their counterparty. A third feature of the investment contract that arguably diminishes consumers’ capacity to make informed choices is that both the investment contract and the product/service offered are “credence goods”. This means that it is impossible for the parties in the contract to know at the time of purchase the future performance of the investment.\(^{18}\)

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\(^{16}\) C. Sergeant, ‘Dealing with Consumers – the Opportunities and the Costs of Getting this Wrong’, FSA Speech (7\(^{th}\) May, 2003).


2.2.4. Economic agency

The principal-agent problem is a dominant feature of the fiduciary relationship under examination and arises whenever there is imperfect information about what action an agent has undertaken or should undertake on behalf of his principal.\textsuperscript{19} Even where the principal can observe the action taken by his agent, the principal is not in the position to know whether the agent took the action he himself would have taken in the given circumstances, because the agent acts on information different from that available to the principal. Since the pay-offs to agents will normally differ from those to the principals, the agent will not in general take the action, which the principal would like him to take in the presence of perfect information.

Consequently, the fact that the financial firm should act as the fiduciary of its customer, does not guarantee that in practice the former will not deviate from its fiduciary duties.\textsuperscript{20} Conflicts of interest, inherent in every agency relationship, may create counter-incentives for complying with contractual obligations. Especially in long-term contracts and in conditions of asymmetric information, the possibility of opportunistic behaviour is increased because the value of the contract and the investment depends on the firm’s performance after the point of purchase.\textsuperscript{21} Contracting out would be a way in which consumers could avoid being exposed into the risk of

\textsuperscript{21} Ramsey, above note 13, 28-37.
their counter-parties’ misconduct, nevertheless, the costs involved discourage them from doing so.  

2.2.5. Moral hazard, adverse selection and sub-optimal production of information

Information asymmetries bear out two additional problems: moral hazard and adverse selection. While the former may occur in the behaviour of either the consumers or the providers of financial services, “adverse selection” crops up where public confidence is low and describes a particular consumer behaviour, which generally distorts competition among financial firms. Consumers are induced to hazardous behaviour that is, taking advantage of other market participants’ activities without sharing the costs involved, in their attempt to overcome all those difficulties they confront when engaging in market transactions or because they show reliance on regulatory measures protecting them. In the case of financial firms, hazardous behaviour is either due to the agency relationship or as a result of adverse selection from the part of consumers.

Moral hazard and adverse selection may expand to the whole industry and take the form of herd behaviour affecting competition and consequently the overall market performance. With regard to retail investors, one could mention two examples of macroeconomic concern.

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22 A corollary problem is the prohibitive costs of gathering information and monitoring compliance. I discuss this below. Above note 17, 9-10.
23 Franks, et al., above note 18, 268-272.
24 Akerlof, above note 14, 488; Ramsey, note 13, 33.
25 Above note 9, 29-30; note 17, 61-64.
The first one is the problem of sub-optimal information. Under these circumstances, one would expect that consumers would feel compelled to do anything they can to gather information and put in place effective mechanisms of monitoring their counterparty’s conduct. However, things are different in reality. Consumers tend to under-invest in information for mainly two reasons: Either because the costs for doing research, hiring monitoring services and operating mechanisms of compliance are prohibitive or because they prefer to “free-ride”.

The second problem that raises issues of macro-economic concern relates to the situation, where the demand for products and services is considerably reduced due to imperfect information and lack of market confidence. With regard to financial intermediaries it suffices to point out that under the same conditions, good firms may be induced to behave badly where they lack the incentive to continue offering high quality of business or to distinguish themselves from their competitors because the anticipated costs are far greater to the benefits of going into trouble to do so.

2.2.6 Summary of the argument for investor protection regulation

The thesis for regulation concludes that the proper means to eliminate “qualitative uncertainty” in the retail financial sector is to put in place conduct of business regulation. By imposing standards and rules of conduct of business more information would be available and the retail investors would be in better position to make efficient choices. It is also desirable that the public authority in charge has certain powers of supervising and

27 Above note 17, 9-10; and D. Llewellyn, ‘Regulation of Retail Investment Services’, 15(2), Economic Affairs, (Spring, 1995), 14.
28 Akerlof, Above n. 14.
monitoring the firm’s behaviour and enforcing claims in case of misconduct. This would decrease the pertinent costs and at the same time enhance the effectiveness of various mechanisms of compliance. It would further aid in maintaining market confidence, strengthen sound competition and in the long run encourage economic growth.\textsuperscript{30} Regulation is not costless.\textsuperscript{31} It is strongly asserted, however, that its benefits will override the anticipated costs.\textsuperscript{32}

2.3. Counter-arguments

2.3.1. Introduction

The thesis against regulation is broader in scope. On the one hand, its adherents question the competence of governmental agencies to regulate financial markets in general and the conduct of investment business in the retail industry in particular. On the other hand, they bring in the surface an additional source of costs that goes hand in hand with regulation; the difficulties associated with the use of legal rules as instruments of social organisation and control.

2.3.2. Defeating the claim that the market fails to respond to qualitative uncertainty efficiently

It is argued that it is wrong to assume that the market fails to respond to the core informational problem of uncertainty about the quality of products and services. The optimal amount of information and, consequently, the optimal

\textsuperscript{30} See above note 9, 26 the discussion on the fall in the sales of life assurance and personal pension products. 

\textsuperscript{31} Franks \textit{et al.}, above note 18, 270-2. 

\textsuperscript{32} C. Briault, 'The Costs of Regulation', \textit{FSA Speech} (10\textsuperscript{th} July 2003).
degree of quality is always determined by the rules of demand and supply. In particular, there are a number of ways in which consumers can get enough information to make informed choices yet, in doing so, they are not left alone. The market furnishes financial services providers with strong incentives to voluntarily provide investors with the information they require. Other things being equal, investors want to purchase financial instruments with the highest expected returns. These returns are reduced by the costs investors must incur to evaluate instruments and assess risks. Therefore, it pays producers of the instruments to reduce these investor-borne costs by determining what information investor’s want and by providing them with this information.

2.3.3. Consumer illiteracy, agency, moral hazard and adverse selection: Four overstated problems

The argument that retail investors are incapable of making informed choices should be rejected, for it is based on the faulty assumption that informed choice requires perfect information. Where consumers calculate the net costs of their transactions and decide to rely on the reputation of the firm or the experiences of other consumers because the cost of research exceed the benefits, they makes an “informed judgement” despite the fact that they are less than perfectly informed. Similarly, it would be a mistake to say that the

33 For a discussion of the various market institutions generating, evaluating and disseminating information see, J. Blundell and C. Robinson, ‘Regulation Without the State’ (1999), Occasional Paper No.109 (Institute of Economic Affairs, 1999); P. M. Booth, ‘Who Should Regulate Financial Institutions?’, Economic Affairs, (Spring 2003), 28 at 29-31; The achievement of informational efficient market, however, appears to be impossible. On that point see above Grossman and Stiglitz, note 13, 393.
35 Ramsey, above note 13, 26.
amount of information produced is sub-optimal, given that it suffices for the parties to decide whether it would be for their benefit to transact or not.

Consumer illiteracy is not the only phenomenon that has been overstated by the proponents of conduct of business regulation. The problems arising out of the agency relationship as well as those of moral hazard on the part of firms and adverse selection on the part of consumers have been embroidered. The firm’s incentives to breach its fiduciary duties are frequently counter-balanced by the incentive to distinguish itself from other competitors. The latter entails investing in the quality of products and services and in the disclosure of information. For the same reason cases of opportunistic behaviour and misconduct in the form of herd behaviour are less common than it is thought, under circumstances of asymmetric information. In any rate, regulation, as a response to these contingencies, cannot be justified in so far these do not create negative externalities, monitoring services are already offered by the market and private enforcement of rights is economically efficient.

2.3.4. Economic agency in non-market context

There is a multiplicity of agency relationships embedded in the institutional structure of a public authority charged with the task to regulate financial markets. Of particular importance are the following two: On the one hand, the agency relationship between the regulators (‘agents’) and retail investors (‘principals’) since the former undertake the commitment to protect the welfare of the latter and generally promote their interests. On the other hand, the agency relationship between the regulators and the regulated

38 Above note 37, 62.
39 Above 51-52.
40 Above note 9.
firms, namely the financial services suppliers.\textsuperscript{41} In this particular case, the regulators are the ‘principals’ and the regulated firms are the ‘agents’ in the sense that they agree to comply with a given regulatory regime.

These two agency relationships are not different from any other case of agency. Informational asymmetries exist and conflicts of interests do arise here as well.\textsuperscript{42} In the absence of any effective mechanism of monitoring and compliance and to the extent the interests of the parties do not coincide, there is ample space for the agent to deviate from one’s initial commitment to further the principal’s interests. The regulated firms have an incentive not to comply with regulation insofar as compliance is not anticipated to bring about optimal outcomes for their business. Regulators will not serve the interests of consumers to the extent in which the implementation of the pertinent policies militate against their self-interests and/or those of their administrative clientele.\textsuperscript{43}

What distinguishes, however, the sketched interaction of interests from any other agency relationship is the following: In the marketplace, competition and the decentralisation of power control the occurrence of conflicts of interest and filtrate the quality of services.\textsuperscript{44} By contrast, in the public domain, it is difficult to establish an effective accountability regime, in view of the complex bureaucratic institutional structure and the monopolistic and centralised character of the government’s political power and its respective administrative agencies.\textsuperscript{45} It is also difficult to make any safe assessment of the value of the services offered by the public authority as means to

\textsuperscript{41} Above note 17, 47-48.
\textsuperscript{42} Above.
\textsuperscript{43} Above note 37, 18, 22 and 23.
\textsuperscript{44} Simpson, above note 19, 51-53.
\textsuperscript{45} Simpson, above note 19, 47; and note 17, 68-72.
appreciate their quality given the absence of a price mechanism equivalent to the one operating in the market.\textsuperscript{46}

2.3.5. The pathology of legal rules and side-effects of regulation

Consumer protection is contingent on the capacity of legal rules to deliver the intended public policy objectives. The use of legal rules, however, is not free from problems.\textsuperscript{47} Rules may regulate more cases than it was initially intended (over-inclusiveness) or vice versa (under-inclusiveness). At the same time, it may be extremely difficult to determine their meaning with certainty (legal indeterminacy). In any rate, it is essential that regulatory standards be designed in such a manner so that the cost of rule-deficiencies is kept at minimum.\textsuperscript{48} With regard to conduct of business rules, recent studies suggest that policy makers have found it extremely difficult to meet this objective. This has been attributed to a range of factors including the use of vague terms (e.g. ‘suitability’, ‘reasonable’, ‘good’ or ‘bad’ advice)\textsuperscript{49} and the fact that drafting conduct of business rules is essentially about setting quality standards which are difficult to determine in advance because they are contingent to entirely individual circumstances and personal consumer tastes.\textsuperscript{50}

A corollary issue is the competence of an administrative public body to define the amount and content of information as well as the way this should be made available to customers.\textsuperscript{51} Given the remoteness of the relationship, how would it be possible for a governmental agency to know what

\textsuperscript{46} Survey techniques help assessing the value of non-market services like regulation but such a “quasi-market mechanism” is not devoid of problems. See above note 17, 68-9.
\textsuperscript{47} J. Black Rules and Regulators (1997), ch.1.
\textsuperscript{49} S. Read, Competition or Regulation: An Alternative Approach to Investor Protection (Adam Smith Institute, 1998), 7.
\textsuperscript{50} Collins and Black, above note 13, 28; and note 19, 49-51.
\textsuperscript{51} Above note 37, 48-49, 55 and 72.
information individual investors might find necessary or useful? This depends on various factors such as tastes, wealth, and risk preferences, and many of them have no generally accepted metrics. By contrast, a financial firm seems to be in a better position to identify the individual needs of each customer and it should be encouraged to do so to the extent the benefits of providing such facilities do not exceed the anticipated costs.

Apart from the difficulties associated with the use of legal rules in the regulatory context, one should not lose sight of the fact that regulation is also liable to bring about a plethora of other side effects. It encourages hazardous behaviour on the part of consumers and imposes constraints on competition and innovation for the overall detriment of consumers. Entry controls and the setting of minimum standards, for example, serve the interests of financial firms and not those of the consumers, because they protect financial services suppliers from being exposed to harder competition. These problems should be taken into account as well when assessing the desirability of conduct of business regulation.

2.3.6. Summary of the argument against investor protection regulation

The argument against regulation concludes that it is competition and not protective policies that further consumer welfare. While cases of market failure and their consequences have been overstated, several other problems have passed unnoticed. For example, no proper attention has been given to various instances of governmental failure, the limitations of regulatory standards to deliver public policy objectives, and the competence of a specialist public agency to know beforehand what is best for each consumer.

52 J. Franks et al., above note 9, 29; note 18, 19-20 and 270-2; and note 17, 62-63, where the author points out that for the majority of consumers, financial regulation appears to be a free good.
53 Above note 37, 62; and Simpson, note 19, 50.
Clearly, market dynamics that could work for the benefit of consumers have not been fully exploited but rather suffocated. On this view, a shift in attitude and a change of focus would serve consumer interests better.

3. The FSA Conduct of Business Regulation

3.1. Introduction

Rules governing the conduct of business of firms with their clients ('investors') stand at the centre of UK financial regulation.\(^{55}\) These comprise the COB Sourcebook,\(^{56}\) a lengthy piece of secondary legislation, which is part of the FSA Handbook of Rules and Guidance.\(^{57}\) Breach of these rules gives rise to a range of remedies. In addition to those provided by the general law of contract, negligence and misrepresentation, the aggrieved party has the right to bring a legal action for damages under section 150 of FSMA. Moreover, contravention of COB requirements may give rise to disciplinary action by FSA.\(^{58}\) Subject to exceptions, COB rules apply to every firm in respect of the activities set out in COB 1.3.1.\(^{59}\)

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\(^{55}\) The common law principles of agency and tort provide an additional layer of investor protection. Although their significance has been gradually marginalized, they still provide a source of interpretive guidance for the proper application of regulatory requirements. M. Blair and G. A. Walker, *Financial Services Law*, (2006), ch.11; and I. McNeil, above note 1, 186-190.

\(^{56}\) There are separate COB rules for mortgages (MCOB) and for non-investment insurance contracts (ICOB). The FSA COB replaced the earlier regime under the Financial Services Act 1986. Its predecessor was a three-tier system of rules generally dealing with identical issues such as disclosure of information, suitability of advice, best execution, customer's understanding of risk, financial promotion ('misleading statements' and 'unsolicited calls'), soft commissions and unfair practices. B. Rider, C. Abrams and E. Ferran, *Guide to the Financial Services Act 1986* (1989), ch. 6. By the end of 2007, the COB Sourcebook will be replaced by the NEWCOB Sourcebook, which will implement the MiFID into the UK. The implementation of MiFID and the key changes that will be introduced are discussed in section 3.12 below.

\(^{57}\) COB rules are part of Business Standards alongside, Conduct of Business rules for non-investment insurance contracts (ICOB), Conduct of Business rules for mortgages (MCOB), Client Assets (CASS), Market Conduct (MAR) and Training and Competence (TC).

\(^{58}\) Above note 55, ch.11. The aggrieved party has also the option to resort to the Financial Services Ombudsman and or use other forms of redress avoiding court litigation. On that point see above I. McNeil, note 1, 190-203.

\(^{59}\) COB 1.2.1 in combination with COB 1.4.1, 2 and 3, which set out the territorial scope of COB rules.
they regulate “designated investment business”\textsuperscript{60} in line with the FSA eleven principles for business. These are the following:

1. “A firm must conduct its business with integrity.
2. A firm must conduct its business with due skill, care and diligence.
3. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. A firm must maintain adequate financial resources.
5. A firm must observe proper standards of market conduct.
6. A firm must pay due regard to the interests of its customers and treat them fairly.
7. 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. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. 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 judgement.
10. A firm must arrange adequate protection for client’s assets when it is responsible for them.
11. 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 of which the FSA would reasonably expect notice.”\textsuperscript{61}

The application of COB rules follows the FSA system of client classification. By and large, COB rules govern dealings with “private customers”, that is consumers of financial services and products (“unsophisticated investors”). COB rules provide consumer protection in a number of ways including by way of provisions requiring the disclosure of information, provisions regulating the quality of advice, and execution of

\textsuperscript{60} The Glossary of the FSA Handbook contains a long and non-exhaustive list of activities that fall within the scope of “designated investment business”. These are, for example, (a) dealing in investments as principal or agent; (b) arranging (bringing about) deals in investments; (c) managing investments; (d) safeguarding and administering investments; (e) safeguarding and administration of assets; (f) establishing, operating or winding up a collective investment scheme; (g) acting as trustee of an authorised unit trust scheme, (h) advising on pension transfers and pension opt-outs etc. See also Part II of the Regulated Activities Order (Specified Activities).

\textsuperscript{61} It should be pointed out that the application of the eleven principles for business is much broader and covers –apart from conduct of business rules (COB) other fields of financial regulation such as the ‘Client Money’ regime (CASS), Market Conduct, the ‘Approved Persons’ regime and ‘Systems and Controls’.
orders, provisions restricting unfair practices and provisions furnishing consumers with certain rights and remedies. Product regulation is not absent but nevertheless rare as, for example, in the case of stakeholder contracts where limited “basic advice” may be given.\textsuperscript{62} Below I offer a brief overview of the main COB rules.\textsuperscript{63}

3.2. Financial promotion, inducements and unsolicited calls

A wide range of COB rules deal with the marketing\textsuperscript{64} of retail investments to the public ("financial promotions").\textsuperscript{65} The overall objective of these regulatory provisions is to protect consumers from the risk of taking decisions on the basis of misleading and/or inaccurate information.\textsuperscript{66} The COB rules on financial promotion should be read in light of section 21 of the Financial Services and Markets Act 2000, which sets out a general restriction of activities constituting “financial promotion” broadly conceived\textsuperscript{67} and of the Financial Promotions Order, which introduces a number of exceptions.\textsuperscript{68} The scope of activities falling within the definition of financial promotion is further refined by a range of extensive guidance as


\textsuperscript{63} The following COB chapters are not included in the discussion: (a) chapter 9 on client assets, since this topic is dealt with separately in CASS; (b) a number of chapters which contain special provisions in relation to the operators of regulated investment schemes (COB 10), trustee and depository activities (COB 11), and Lloyd’s (COB12) and; (c) chapter 8A, which deals with the handling of claims in relation to long-term care insurance contracts.

\textsuperscript{64} The marketing of financial services and products involves the use of newspaper, television and website advertisements, brochures, mailshots, telemarketing, sales aids and marketing activity in the form of letters, telephone calls and meetings. Articles 12 to 73 of the Financial Promotions Order contains numerous exceptions, which are further regulated by PERG 8.

\textsuperscript{65} M. Blair and G. A. Walker above note 55, ch.11 at paras. 60 to 71.


\textsuperscript{67} Breach of the restriction that is set out in section 21 is a criminal offence (section 25 FSMA), whereas resulting agreements are prima facie unenforceable (section 30 FSMA). The FSMA provisions on financial promotions replace the earlier regimes of investment advertisement and unsolicited calls. It intends to be medium neutral.

to the application of the financial promotion restriction, the exemptions, and the conditions applying.

In particular, section 21 of the FSMA states that “a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless the communication is made or approved by an authorised person”. In accordance with section 21, chapter 3 of COB contains more specific rules on financial promotion, which run in parallel with other FSMA and COB provisions as, for example, the rules on financial advice in chapter 5 of COB. Specifically, COB 3 provides rules and guidance for a firm, which wishes to communicate or approve a financial promotion, by amplifying the content of Principles 6 (customers’ interests) and 7 (communication with client) of the FSA Handbook. Some of the provisions are applicable to all types of financial promotions, while others apply only to specific types of financial promotions that is, real time financial promotions, non-real time financial promotions and direct offer financial promotions.

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69 In light of section 21 (13), communication is broadly defined to include any activity, which is aimed at causing a future communication. The concept of inducement refers to those situations where the degree of incitement goes beyond the provision of purely factual information (PERG 8.4). Engaging in investment activity is also defined widely by reference to controlled activities and controlled investments (section 21 (8) and (9) FSMA and Schedule 1(4) of FOP. In accordance with section 31 FSMA, ‘an authorised person’ is one of the following: (a) a person who has a Part IV permission to carry one or more of the regulated activities; (b) an incoming EEA firm; (c) an incoming Treaty firm; (d) a UCITS qualifier; (e) an ICVC; (f) the Society of Lloyd’s. See also GEN 2.2.18 for the position of an authorised partnership or unincorporated association, which is dissolved. M. Blair and G. A. Walker, above note 55, ch.11 para. 64.


71 It may also be necessary to consider other areas of law including industry codes as, for example, the British Code of Advertising, Sales Promotion and Direct Marketing.

72 The meaning of ‘communicate’ and ‘approve’ is explained in COB 3.2.1.

73 See COB 3.5.2.

74 In accordance with article 7 (1) of the Financial Promotions Order, a real time financial promotion, is a promotion that is made in the course of a personal visit, telephone conversation or other interactive dialogue. See also COB 3.5.5 (1).

75 In accordance with article 7 (2) of the Financial Promotions Order, a non-real time financial promotion is any form of financial promotion that does not fall within the definition of real time financial promotion in Article 7 (1). See also COB 3.5.5 (2).

76 According to the Glossary’s definition, a direct offer financial promotion is a financial promotion which contains: “(a) (i) an offer by the firm or another person to enter into a controlled agreement with anyone
According to COB 3.8, financial promotions should be clear, fair and not misleading. Firms are under the obligation to confirm that financial promotions comply with the COB rules. Due to their nature and the risks that trigger to consumers, unsolicited real time financial promotions are dealt with separately. COB 3.10 introduces a general prohibition of real time unsolicited promotions, subject to the exceptions set out in COB 3.10.3, as, for instance, where the recipient of the unsolicited real time financial promotion is in an existing customer relationship with the firm. Chapter 3 of COB further contains special guidance for financial promotion through electronic means (e.g., email).

COB 2 imposes an additional requirement to a firm. With the view of avoiding conflicts of interest, it requires a firm to abstain from marketing a product or service to another person, if this is likely to engender a material conflict with duties that a firm owes to its customers. In the same spirit, COB 2.2.6 requires that inducements from a product provider to a firm advising private customers on packaged products must not be such as to induce material bias as regards the choice of product. It should be noted, however, that there is a detailed list of “indirect benefits” that fall outside

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76 COB 3.8.4 and 3.8.22. The implementation of MiFID will bring about a range of changes with respect to communication with clients. This is briefly discussed in sub-section 3.12 below.
77 COB 3.6.
78 In accordance with article 7 (1) of the Financial Promotions Order, a real time financial promotion, is a promotion that is made in the course of a personal visit, telephone conversation or other interactive dialogue.
80 See also Principles 1 and 6.
the scope of the above-mentioned rule prohibiting inducements. A standard example, in this connection, is the supply of product literature.\textsuperscript{81}

3.3. Client classification

Client classification is set out in COB 4.1.4.\textsuperscript{82} According to this provision, a firm’s customer may fall in one of the following three categories: he might be either a “private customer” or an “intermediate customer” or “market counterparty”.\textsuperscript{83} Private customers receive the greatest level of protection, since in this category fall unsophisticated investors that is, consumers of financial products and services. Market counterparties, stand at the other far end of the spectrum, while intermediate customers are found in the middle. In the retail sector the assumption is that the customer will be a private customer. The purpose of imposing to the firm the obligation to classify its customers before carrying out any of the “designated activities” is to ensure that regulatory protection is focused on those clients that it is needed most, “while allowing an appropriately light touch approach for inter-professional business”.\textsuperscript{84}

3.4. Terms of business and client agreement

\textsuperscript{81} COB 2.2.7. Other examples are joint marketing exercises, seminars, conferences and technical services. I. McNeil, above note 1, 180-181.
\textsuperscript{82} M. Blair and G. A. Walker, above note 55, ch.11 para.72. Special provisions deal with client classification in other contexts as, for example, in the case of collective investment schemes, exchanges and clearing houses. See notably, COB 4.1.7A, 4.1.8A and 4.1.9A. A new client classification regime will be introduced by the end of 2007 as a result of the implementation of MiFID into the UK. See section 3.12 below.
\textsuperscript{83} Examples of intermediate customers include local authorities, a body corporate whose share has been listed or admitted to trading or any EEA exchange, a special purpose vehicle, a collective investment scheme etc. Examples of market counterparty include governmental or quasi-governmental bodies, a recognised investment exchange when it is not classified as intermediate customer, a clearing-house when it is not classified as an intermediate customer etc. A private customer is a client who is not intermediate customer or market counterparty including an individual who is not a firm, an overseas individual who is not an overseas financial services institution etc.
\textsuperscript{84} COB 4.1.3. A different client categorisation is set out in MiFID, which will substitute the existing one. This is briefly discussed in sub-section 3.12 below.
A firm is expected to provide its customers with information about how it intends to do business with them. To this effect, it must furnish its clients with the terms of business and a client agreement (COB 4.2). The terms of business contain all contractual terms and conditions in conformity with COB 4 Annex 2. These must be made available to the customer well in advance (“good time”) so that he has enough time to make up his mind. The terms of business may be changed unilaterally without the customer’s consent. In this case, however, the firm is under the obligation to give at least ten days notice and keep record of any amendments. Apart from client classification, and the provision and content of terms of business and client agreements, chapter 4 of COB deals with a number of other issues. One of them is set out COB 4.3, which requires the disclosure of key information to private customers with respect to services fees and commissions of packaged products.

3.5. Managing conflicts of interest

In light of Principle 8, COB 7.1.3 aims to ensure that a firm pays due regard to the interest of its customer and manages conflicts of interest fairly. Conflicts of interest may occur either between the firm and its

83 M. Blair and G. A. Walker, above note 55, ch. 11 at paras. 73 to 82 and; note 1, 176.
84 COB 4.2 amplifies Principle 6 (customers interest) and Principle 7 (communication with clients). See, COB 4.2.4.
85 This requirement does not apply in case of telephone calls. See further COB 4 Annex 1(1).
86 COB 4.2.13 and COB 4.2.14.
87 Packaged products are defined as: “(a) a life policy; (b) a unit in a regulated investment scheme; (c) an interest in an investment trust savings scheme; (d) a stakeholder pension scheme; whether or not (in the case of (a), (b) or (c) held within a PEP, an ISA or a CTF and whether or not the packaged product is also a stakeholder product.”
89 Most of COB rules in chapter 7 (dealing and managing) apply to customers that is, to private customers and intermediate customers. Despite their application to private customers they do not necessarily apply to retail products. COB 7.1, 7.7, 7.12 to 7.17 and COB 7.5, which provides an example of retail products (notably, the purchase of life policy or of unit in a regulated CIS from the scheme operator) where the duty of best execution does not apply. M. Blair and G. A. Walker, above note 55, ch. 11, paras. 51 to 54. The regulatory requirements on conflicts of interest will be removed from the Conduct of Business Sourcebook
customer, either between two different customers of the same firm. Specifically, it prohibits firms to “knowingly advice or otherwise deal in relation to a transaction in which the firm has or may have a material interest or in relation to a transaction that gives rise or may give rise to conflicts of interest”.

In managing conflict of interests, the firm has the option (a) to disclose the interest to the customer; (b) to rely on policy of independence; (c) to establish internal arrangements (Chinese Walls) or (d) to decline to act for a customer. This is simply a guidance on what may constitute “reasonable steps” in managing conflicts of interest and, as paragraphs 2 and 3 of COB 7.1.4 make clear, contravention (or alternatively compliance) with this guidance will only be treated as “tending to establish” contravention (or compliance as the case may be) with the rule set out in COB 7.1.3. It is argued that this bears out legal uncertainty, given that conformity with this rule does not guarantee exclusion of liability.

and further changes will be introduced as a result of the implementation of MiFID in the UK. The reform of the conflicts of interest regime is briefly considered in sub-section 3.12 below.

92 The term “customer” refers to the private customer and “intermediate customer”. Certain provisions of chapter 7, however, apply one to private customers. See for example, COB 7.8 and 7.11, which mainly relate to investment and portfolio managers and regulate activities such as the realisation of private customers assets, lending, margin requirements and non-exchange traded securities.

93 For the rule to apply suffice is the probability that the transaction in question will give rise to conflicts of interest.

94 The concept of “material interest” is defined in the Glossary as “any interest of material nature other than (a) disclosable commissions on the transactions (b) goods or services which can reasonably be expected to assist in carrying on designated investment business with or for clients and which are provided or to be provided in compliance with COB 7.18.3 (use of dealing commission to purchase goods or services).”

95 COB 7.1.4 (1).

96 Special rules regulate deal with each of these options for managing conflicts of interest separately. COB 7.15, 7.1.6, 7.1.7, 7.1.8, 7.1.9.

97 COB 7.1.10 establishes additional requirements for broker fund advisers, the operator of the broker fund adviser and to long-term insurers.
As it was mentioned above, one of the methods for managing conflicts of interest is the establishment of Chinese Walls. These are communication barriers between members or departments of the same financial institution whose objective is to ensure that no improper trading occurs. The provision of Chinese Walls is specifically dealt with in COB 2.4.4. Failure to comply with these requirements deprives the firm from certain defences against a legal action brought either under section 147 FSMA 2000 or any action for damages brought under section 150 FSMA 2000. Furthermore, conformity with Chinese Walls requirements safeguards a firm against allegations of market abuse.

3.6. Advising and selling

Part of a firm’s obligation is to make sure that private customers are adequately informed about the nature of the advice they receive and that they have a clear picture about the scope of the products as well as the capacity of the product providers on which their advice is based upon. To this effect chapter 5 of COB contains a number of requirements for firms. One of them is the so-called “know your customer rule”. According to COB 5.2, a firm must obtain sufficient information about its private customer and keep records of the personal and financial circumstances of its customer for at least three years. FSA considers that this piece of information is crucial for otherwise the firm will be unable to comply with the additional requirement of ensuring the suitability of advice to its

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99 COB 2.4. In practice, for multi-disciplinary investment firms, Chinese Walls are not only permitted but they are considered essential.

100 COB 2.4.5.

101 On market abuse see section 118 and Part VIII of FSMA 2000.

102 M. Blair and G. A. Walker above note 55, ch.11 at paras. 83 to 89; FSA v Fraser & Ors, [2001] WL 1612602.

customers needs.\textsuperscript{104} The suitability rule in COB 5.3.5 applies with respect to personal recommendations to private customers, to income withdrawals, pension transfers and opt-outs.\textsuperscript{105} In case of packaged products, the firm must choose the most suitable product from the range of packaged products on which advice is given to the client.\textsuperscript{106} In the absence of a suitable product within the range advised upon, no recommendation can be made.\textsuperscript{107} Moreover, the firm must furnish the customer with a suitability letter, which explains why the firm has concluded that the transaction is suitable for the customer. The suitability letter must contain a summary of the main consequences and possible disadvantages of the transaction and overall be in conformity with the guidance laid out in COB 5.3.30.

An additional obligation for a firm carrying out activities in the retail sector is to take all reasonable steps so that its customer understands the risks involved in the transaction.\textsuperscript{108} The rule is established in COB 5.4.3 and applies where a firm makes “a personal recommendation, acts as a discretionary investment manager or arranges/executes a deal in warrant or derivatives”. A plethora of evidential provisions purport to clarify when the firm will be deemed to have taken reasonable steps, while in various occasions –notably for warrants and derivatives- the firm must furnish its customer with written risk warnings in the form specified by the relevant COB.\textsuperscript{109}

Moreover, COB 5.1.6A makes possible for a firm to select products either from the whole market, or from a limited number of product providers or

\textsuperscript{105} COB 5.3.5 (1) (a).
\textsuperscript{106} COB 5.3.5 (2) (a). See also G. McMeel and J. Virgo, above note 103 , ch. 14, paras 62-66.
\textsuperscript{107} COB 5.3.5 (2) (b).
\textsuperscript{108} I. McNeil, above note 1, 179-180.
\textsuperscript{109} COB 5.4.6 and Annex 1.
from a single provider. Yet, in doing so, a firm “must not hold itself out as the packaged products producer”. In the same vein a firm “must not… say anything which may reasonably lead a customer to be mistaken as to the identity of the product’s producer” or describe itself as “acting independently”. In any case, the firm must keep a written and accurate record of the scope of advice, which it can give and the range of packaged products to be advised upon. A firm may change the scope of the advice but before doing so it must communicate to its customer any changes by way of a durable medium.

Finally the “basic advice” regime in COB 5A deserves special attention. This is a simplified advice process, and it intends to make the provision of financial advice simpler, quicker, more accessible and cost effective for consumers. The principal rule on the provision of basic advice is that the sales process must incorporate the questions that are set out in COB 5A.4.1. Recommendation of a stakeholder product cannot be made unless the firm considers that the recommendation is suitable to its customer needs and has reasonable grounds to assume that the consumer understands the advice and the basis on which it was given.

3.7. Best execution

110 Before the abolition of the polarisation regime and up till 2005, advisers had to be either “independent” offering advice for a selection of products from the whole market or “tied” offering advice on the products of just one supplier.
111 COB 5.1.6.F and COB 5.1.11A. See further, M. Blair and G. A. Walker above note 55, ch.11 para. 77.
112 This applies to both the firm itself and to its appointed representatives. COB 5.6.1D and E.
113 For the definition of stakeholder products see article 52B (3) of the Regulated Activities Order and Stakeholder Regulations (SI 2004/2738).
114 COB 5A.4.2. M. Blair and G. A. Walker above note 55, ch.11 para. 89.
The regulatory requirements of best execution are dealt with in COB 7.5.\textsuperscript{115} This provision sets out a range of standards that are applicable to firms when executing customers’ orders in designated investments –particularly in the securities and derivatives markets.\textsuperscript{116} The purpose of these standards is to amplify the requirement of conducting business with due skill, care and diligence (Principle 2) paying due regard to the customers interests (Principle 6). The rule in COB 7.5 is subject to the exceptions of COB 7.5.4. Examples of these exceptions include customer’s order for the purchase of life policy, customer’s order for the sale of units in a regulated investment scheme and customer’s order for personal pension scheme. To provide best execution a firm must (1) take reasonable care to ascertain the price which is the best available for the customer order in the relevant market at the time for transactions of the kind and size concerned; and (2) execute the customer order at the price which is no less advantageous\textsuperscript{117} to the customer, unless the firm has taken reasonable steps to ensure that it would be in the customer’s best interests not to do so.\textsuperscript{118} COB 7.5.6 contains a range of evidential provisions concerning the taking of reasonable steps under COB 7.5.5. For example, a firm must disregard any charges and commission made by it or to its agents that are disclosed to the customer under COB 5.7.\textsuperscript{119} In addition a firm needs to have access to competing exchanges, or to all or a minimum number of available price sources etc.

\textsuperscript{115} M. Blair and G. Walker, above note 55, para. 109; and I. McNeil, note 1, 185. In light of the implementation of MiFID in the UK, the best execution regime will be reformed. This is discussed in subsection 3.12 below.

\textsuperscript{116} COB 7.5.1, COB 7.5.2 and COB 7.5.3.

\textsuperscript{117} COB 7.5.8 offers by way of guidance an example where a firm may execute a customer order at a price, which is less advantageous than the best available price. This is when a firm has a continuing relationship with a customer, and reasonably expects that it will be able to secure compensating advantages for the customer over a period or a series of transactions.

\textsuperscript{118} COB 7.5.5.

\textsuperscript{119} COB 7.5.7 provides guidance as to the disclosure of charges and commission in relation to non-standard settlement under COB 7.5.6 (4)(c).
The firm has also the duty to ensure the timely execution of client’s orders.\textsuperscript{120} Timely execution is dealt with in COB 7.6. It applies to a firm when it agrees or it has decided in the exercise of its discretion to execute a current customer order in a designated investment.\textsuperscript{121} It requires a firm to select the most appropriate time to execute the current customer order.\textsuperscript{122} Once a firm has agreed or decided in its discretion to execute a current customer order in a designated investment, it must do so as soon as reasonably practicable.\textsuperscript{123}

In assessing timely execution, it is important to define when a transaction is deemed as executed. With the exception of orders executed in normal market hours, where things are straightforward, there is a range of situations where ambiguity lurks as, for example, in the case of trading outside normal market hours or when a firm allocates a customer order with an own account order or with another customer order. These issues are now addressed in COB 8.1.12. According to this rule, when a firm executes outside normal market hours, the transaction must be treated as executed on the following business day.\textsuperscript{124} Similarly, when a firm allocates a customer order with an own account order or with another customer order, the transaction must be treated as executed at the time of allocation. Other important FSA provisions include COB 7.6.6, which offers guidance as to when a firm should take particular care to assess the timing of execution,

\textsuperscript{120} “Timely execution” amplifies Principle 2 (skill, care and diligence) and Principle 6 (customers’ interests) and it is subject to the exception introduced in COB 7.6.5.
\textsuperscript{121} According to the Glossary, a current customer order is “(a) a customer order to be executed immediately; (b) a customer order, which is to be executed only on fulfilment of a condition after the condition have been fulfilled.”
\textsuperscript{122} COB 7.6.1, 7.6.2, 7.6.3.
\textsuperscript{123} COB 7.6.4. COB 8.1.12 states when a transaction is treated as executed.
\textsuperscript{124} In relation to transactions that are done or to be done in the UK, “business day” is any day which is not Saturday, Sunday, Christmas Day, Good Friday or Bank Holiday. In relation to transactions that are done or to be done outside the UK, ‘business day’ is any day, which that market is normally open to business. See the Glossary definition of ‘business day’ and section 167 of the Companies Act 1989 (recognised exchanges and clearing houses).
and COB 7.6.8, which requires record keeping in conformity with COB 7.12.

3.8. Unfair practices

In light of Principle 6, which requires a firm to pay due regard to the interests of its customers and treat them fairly, a number of COB rules prohibit unfair practices. Specifically, COB 2.5 provides that firms are not allowed to exclude or restrict any duty or liability they may have to their customers. Similarly, COB 5.6.3 stipulates that firms must not impose excessive charges to private customers and lays out a number of factors to be taken into account in determining whether charges are excessive. These include “competitors’ charges, the nature and extent of disclosure, and whether the charges constitute a breach of the trust placed in the firm by the customer”. Special care has been taken in relation to distance contracts. In this connection, COB 2.6 rules inter alia that pre-contract information must be consistent with the applicable law if the contract were concluded and that if the customer requests the firm to change the means of communication, then the firm must comply with that request.

Finally, churning and switching are prohibited. In this respect, COB 7.2 explicitly states that firms should enter into transactions with unnecessary frequency. Similarly, a firm should not switch a private customer within or

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125 M. Blair and G. Walker above note 55, ch. 11 at paras. 55 to 57; I. Mc Neil, note 1, 181-182 and; G. McMeel and J. Virgo, note 103, ch 14 paras 74-76.

126 M. Blair and G. Walker above note 55, ch. 11 at para. 57. The Glossary defines a “distance contract” as “any contract concerning financial services, the making or performance of which constitutes or is part of a regulated activity including, a regulated activity that was concluded under an organised distance sales or service provision scheme run by the contractual provided of the service who, for the purpose of that contract, makes exclusive use (directly or through an intermediary) of one or more means of distance communication up to and including the time at which the contract is concluded.”

127 An example of churning in packaged products is when a firm recommends a house buyer to replace his existing endowment policy with a new one, which he will have to buy for the whole sum borrowed, because the alternative of retaining the existing endowment policy produces less commission for the firm. M. Blair and G. Walker above note 55, ch. 11 at para. 110.
between packaged products unnecessarily. In the same spirit, COB 7.2.3
makes clear that firms must not deal or make personal recommendations,
unless they have taken all reasonable steps to ensure that this is in the best
interests for their clients.

3.9. Withdrawal and cancellation rights

COB rules furnish customers with the right to withdraw (COB 6.7.19) from
or cancel (COB 6.7.5A) an investment contract. The purpose of these rules
is to give customers appropriate time for reflection during which they can
decide whether to proceed with their transaction or not.\textsuperscript{128} Whereas
withdraw rights can be exercised before a contract has been concluded,
cancellation rights arise after the conclusion of the contract.\textsuperscript{129} The right to
cancel must be sent to the customer within 14 days of the conclusion of the
contract and within 8 days if shortfall provisions apply.\textsuperscript{130} It may be
exercised by way of serving a notice or communicated electronically.\textsuperscript{131} A
notice on paper or other durable medium must be treated as served when
dispached, rather than when received.\textsuperscript{132} The firm has the duty to inform its
retail customer about his right to cancel in accordance to COB Appendix
1.1 (17). If it fails to do so the contract remains cancellable and the retail
customer will not be liable for any shortfall.\textsuperscript{133} Where the cancellation right
is validly exercised, the firm must repay within 30 days any sums received
subject to certain deductions that the firm may be entitled to.

\textsuperscript{128} COB rules on pre-sale withdrawal and post-sale cancellation rights should be read in conjunction with
Principle 6, which requires a firm to pay due regard to the interest of its customer and treat them fairly. M.
Blair and G. A. Walker, above note 55, ch. 11, paras. 100-104.
\textsuperscript{129} I. McNeil, above note 1, 184-185.
\textsuperscript{130} COB 6.7.30 and COB 6.7.57.
\textsuperscript{131} COB 6.7.27 and COB 1.8.
\textsuperscript{132} COB 6.7.44.
\textsuperscript{133} COB 6.7.41.
3.10. Post-trade reporting requirements

Firms conducting business with unsophisticated investors must comply with a number of post-trade reporting requirements, whose purpose it to ensure that customers are kept updated and promptly advised about essential details of their transactions. These constitute the subject matter of Chapter 8 of COB. Among the post-trading reporting requirements figure the provision of a written confirmation of the transaction and the provision of periodic statements. Although confirmations and periodic statements are permitted in electronic form, certain conditions must be satisfied. Specifically, firms must have in place all appropriate arrangements to ensure their secure transmission, their receipt, they should be able to verify their authenticity and further demonstrate that their customers wish to communicate in electronic form.

According to COB 8.1.3, a firm must dispatch a written confirmation of the transaction no later than the business day following the day the transaction was executed. This rule is subject to a number of exceptions as, for example, life policies and personal pension contracts. Furthermore, confirmation is not necessary where the customer has agreed that it need not be supplied. The content of the confirmation must be in conformity with the evidential provisions of chapter 8. The firm is further expected to make a copy of the confirmation for record-keeping purposes.

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134 Specifically, COB 8.1.2 and COB 8.2.3. Chapter 8 of COB implements Principle 7, which requires that every firm pays due regard to the information needs of its customer.
135 COB 8.1.4, COB 1.8.1 and GEN 2.2.14.
136 COB 1.8.2.
137 COB 8.1.5 (2).
138 COB 8.1.6.
139 In case of private customer the agreement must be in writing.
140 COB 8.1.15 (general requirements), COB 8.1.16 (additional content in particular circumstances), COB 8.1.17 (additional content in relation to transactions in units in regulatory collective investments, COB 8.1.18 (additional content in relation to derivatives) and COB 8.1.19 (additional content in relation to options).
Alongside a written confirmation, a firm must furnish the customer with periodic statements containing information on the customer’s investment portfolio. The rule is set out in COB 8.2.4, which should be read in conjunction with a range of evidential provisions specifying inter alia the content, promptness and adequacy of information. The firm must keep records of the periodic statements, unless the customer has requested the firm not to do so or the firm has taken reasonable steps to establish that the customer does not wish to receive them (COB 8.2.6).

3.11. Claims handling

In light of Principles 3 (management and control), 6 (customer’s interests) and 8 (conflicts of interest), chapter 8A of COB governs the handling of clients’ orders and regulates claims made by or one behalf of policyholders of long-term care insurance contracts. 141 It sets out regulatory requirements, whose purpose is (a) to ensure that claims are handled “fairly and promptly”; 142 (b) that policyholders are provided with information on the claim handling process as well as with an explanation of when a claim is rejected or not settled in full and (c) that conflicts of interest are managed appropriately. 143 These regulatory requirements create a range of duties for firms. 144 Alongside the general duty to handle client orders up to the standards set out in COB 8A.4, insurers must in addition comply with more specific requirements including the obligation to give policy holders reasonable guidance on how to make a claim, not to reject a claim unreasonably and to keep records. 145

141 COB 8A.1.1 to 5.
142 COB 8A.2.2, COB 8A.2.3 and COB 8A 2.4 in combination with COB 8A.4, SYSC 3.2 and TC1.
143 COB 8A.1.6 (1).
144 That is the insurer or the managing agent as the case may be. See COB 8A1.2.
145 COB 8A.2.5, COB 8A.3, COB 8A.4 and COB 8A.5.

The COB Sourcebook has been the subject of extensive review during the past three years and it will soon be replaced by a new Sourcebook (NEWCOB Sourcebook). The catalyst of this review has been the implementation of the Markets in Financial Instruments Directive (MiFID), a EU legal instrument that arguably is the epicentre of the European Union’s Financial Services Action Plan. MiFID comprises two levels of European legislation. ‘Level 1’, the Directive itself, was adopted in April 2004. ‘Level 2’ measures –also known as ‘technical implementation measures’– were developed by the Commission on the basis of advice received from the Committee of European Securities Regulators (CESR). They were the subject of extensive negotiations and compromise and published in the Official Journal of the European Union on 2 September 2006.

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The Markets in Financial Instruments Directive will come into effect on 1 November 2007 and will replace the existing Investments Services Directive (ISD).\(^{149}\) Similarly to ISD, MiFID aims at setting out provisions governing the internal organisation of firms and conduct of business requirements as well as harmonising a number of conditions governing the operation of regulated markets. It differs, however, in that it introduces significant changes to the regulatory framework in order to reflect developments in financial services and markets since the adoption of ISD. One of these changes is the widening of the scope of the “core investment services and activities” that firms can passport. In addition to those investments services and activities provided by ISD, MiFID covers a range of other services and activities such as (a) advice involving personal recommendations to a core investment service; (b) the operation of a multilateral trading facility (MTF) and (c) commodity derivatives, credit derivatives and financial contracts for differences.\(^{150}\) Furthermore, a plethora of ISD provisions have been redrafted in order to describe with greater clarity and certainty the allocation of jurisdictional competences between the home-member State and the host-member State. Other novelties include measures such as pre-trade and post-trade transparency requirements for equity markets, the creation of a new regime for “systematic internalisers”\(^{151}\) and more extensive transaction reporting requirements.

With respect to conduct of business requirements, MiFID covers nine key areas of activity: (a) client classification; (b) marketing; (c) information about...

\(^{149}\) Directive 93/6 EEC and discuss the rationale for amending its requirements with a new Directive.

\(^{150}\) In practice this means that MiFID will affect a greater number of firms including investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms and some commodities firms. In certain occasions, however, things are less clear. Retail banks and building societies will be subject to MiFID for some parts of their business (e.g. when selling securities or investment products) –but not others.

\(^{151}\) The term “systematic internaliser” is defined in Article 4 (1) of MiFID.
the firm and its services; (d) client agreements; (e) suitability and know your customer; (f) appropriateness and execution-only services; (g) best execution; (h) client order handling; (i) reporting information to clients. While the substantive requirements established in MiFID are by and large consistent with existing FSA requirements, novelties are not rare.\textsuperscript{152} Several key points of departure from the present regime are briefly discussed in the remaining paragraphs of this sub-section.

To begin with, MiFID introduces a different classification system.\textsuperscript{153} It categorises clients as “retail clients”, “professional clients” or “eligible-counterparties” namely it places them into categories that are conceptually different from their FSA equivalent. Similarly, it changes the criteria and procedures for permitting a client to be treated as though it falls within a different category. For instance, under MiFID a firm is under the obligation to notify its client of his right to request a different categorisation. It is also interesting to note that whereas MiFID makes it more difficult to opt-up from the retail sector, it relaxes the requirements under which eligible counterparties and professional clients will be able to request greater regulatory protection than they are normally entitled to.\textsuperscript{154}


\textsuperscript{154} FSA, Implementing MiFID’s Client Categorisation Requirements (August 2006), para.1.9. It should be noted that the Directive contains certain transitional –also known as ‘grandfathering’ provisions– as for example Art 71(6) on client classification. J. Long (FSA Retail Policy), ‘Reforming Conduct of Business Regulation’ (15 November 2006). The paper was presented in SII Compliance Forum. FSA, ‘Understanding the Basics
Communication with clients and product disclosure are two additional areas where the implementation of MiFID is expected to bring about changes. In relation to client communication, although the core requirement of clear, fair and not misleading communication will remain the same, the new regime will apply more widely than the existing COB regulation covering all clients and all communications and affecting MiFID and non-MiFID firms as, for example, life insurance companies. Furthermore, additional information disclosure requirements will be introduced in relation to the provision of services such as advice. With respect to product disclosure, article 19 (3) sets out a number of requirements that firms must comply with while, at the same time, the attempt is made to simplify the requirements on packaged products.

One finds further points of deviation from the present regime in MiFID provisions dealing with conflicts of interest. The first notable difference will be that provisions on the management of conflicts of interest will no longer be part of the conduct of business Sourcebook. These materials will be moved to a more appropriate location and constitute part of the FSA regulatory provisions on Organisational Systems and Controls for common platform firms. The second remarkable difference is that the Directive sets out a much more detailed and prescriptive regime. According to FSA regulation, in managing conflicts of interest, firms have the following

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of the new Conduct of Business sourcebook (COBS) for retail markets’ (September 2007); C. Skinner (ed), The Future of Investing in Europe’s Markets after MiFID (2007), 19 and ch. 4.
156 It is worth noticing, however, that with regard to financial promotions there is less product specific prescription and some degree of deregulation. See N. Moloney above note 153, 599-600; and J. Long, above note 154.
157 These will be set out in Senior Management Arrangements Systems and Controls and, in particular, SYSC 10, which will replace chapters 7.1, 5.10 and 2.4 of the COB Sourcebook. This is further discussed in Chapter Three, page 145 below.
158 Conflicts of interest are dealt with in article 18 of MiFID. See also articles 21 to 23 of the implementing Directive (Commission Directive 206/73/EC of 10 August 2006).
options: to disclose the interest to the customer, or rely on policy independence, or establish eternal arrangements or simply decline to act for a customer. The four options will no longer have equal weight and disclosing conflicts of interest will no longer automatically amount to conflict managed.\(^\text{159}\) In conformity with MiFID, the NEWCOB regulation will permit disclosure only as a last resort measure provided that a firm is satisfied that it is an appropriate tool to use compared with other methods. Finally, client classification is no longer relevant for the purposes of managing conflicts of interest requirements. This is a significant departure from existing FSA requirements –specifically, PRIN 8- which does not apply in relation to market counterparties.\(^\text{160}\)

The FSA best execution regime will also undergo major changes.\(^\text{161}\) In this relation, the firm’s duty to obtain the best possible result for its client is of particular interest. Under the FSA COB Sourcebook, a firm must take reasonable care to ascertain the best available price for the customer order. It is not part of its duty, however, to have access to competing Exchanges or to at least a minimum number of price sources. This is going to change, for article 21 MiFID provides that a firm must take all reasonable steps to obtain the best possible result, taking into account a number of prescribed factors: price, costs, speed, likelihood of execution and settlements, size, nature, or any other consideration relevant to the order.\(^\text{162}\) Under current COB rules a firm is allowed to agree with its intermediate customers that it will not provide best execution. Furthermore, certain spread betting, venture capital and stock lending are excluded from the FSA best execution regime.


\(^{160}\) Above, para 9.8.

\(^{161}\) FSA, ‘Implementing MiFID’s Best Execution Requirements’, FSA DP 06/3 (May 2006); and N. Moloney, above note 153, 621-634.

\(^{162}\) Article 21 of MiFID is further explicated by articles 44 to 46 of the implementing Directive (Commission Directive 2006/73/EC of 10 August 2006).
By contrast, MiFID neither permits clients to waive best execution protection nor provides for certain trading practices that are excluded for best execution requirements.

Finally, the MiFID appropriateness regime deserves special attention, as it is quite novel and unparalleled. Appropriateness should not be confused with suitability. These two requirements will run in parallel and will be complimentary, in that appropriateness requirements will be applicable to non-advised (that is “execution only”) services. The appropriateness regime will be introduced in the UK with the NEWCOB Sourcebook and will cover a wide range of investment firms including firms, which do not provide investment advice or discretionary investment management services. Providers of execution-only services with respect to non-complex financial instruments, bonds or other forms of securitised debt and UCITS do not fall within the scope of the MiFID appropriateness regime.

4. Conclusion

This introductory chapter considered the case study of this thesis, namely the FSA regime on conduct of business regulation and focused on the following two issues: On the one hand, the economic rationale for investor protection regulation by means of conduct of business rules and, one the other hand, the subject matter of the FSA conduct of business regime, as it is presently crystallised in the FSA Handbook of Rules and Guidance.

163 MiFID, Article 19 (3), (4) and (5) subject to the exceptions introduced in 19 (6); J. Long, above note 154; N. Moloney, above note 153, 614-620; and FSA, ‘Reforming COB Regulation’, FSA CP 06/19 (October 2006), chapter 15.

164 The Level 2 Directive sets out criteria for determining which other types of financial instruments should be considered non-complex.
With respect to the economic justification for conduct of business regulation it was pointed out that supporters of investor protection regulation doubt the capacity of the market to perform its self-corrective function in order to protect consumers of financial products and services. In their view, the only sound response to the informational problems that pose a constant threat to consumer welfare is public regulation—in this particular case, a conduct of business regime regulating the behaviour of financial services providers in the retail financial sector. Sceptics of regulation hold the diametrically opposite view. They content that it is competition and not protective policies that further consumer welfare. Insofar as common law controls cases of fraud and negative externalities, the remedial performance of market forces is more than satisfactory. They reject the thesis for investor protection regulation by way of rules governing conduct of business because, as they explain, supporters of regulation tend to exaggerate cases of market failure and play down governmental failure.

Despite the controversy surrounding the economic justification of conduct of business regulation, the Financial Services Authority is a strong advocate of regulation dedicated to protect consumers of financial products and services. Not only do conduct of business rules figure as one of the most important pieces of secondary legislation but also consumer protection is included among the statutory objectives that the FSA is bound to pursue. At present, the core body of conduct of business requirements is set out in the Conduct of Business Sourcebook of the FSA Handbook and deal with a variety of issues such as: (a) client classification, (b) financial promotion, (c) disclosure of information before, during and after the transaction, (d) suitability of advice, (e) best execution and (f) unfair practices. However, in 1 November 2007, the Conduct of Business Sourcebook will be replaced with the New Conduct of Business Sourcebook (NEWCOB).
The NEWCOB will implement the Markets in Financial Instruments Directive (MiFID), which is arguably the centrepiece of the European Financial Services Action Plan. The implementation of MiFID is going to affect FSA regulation in two levels. It will bring about changes in the content of conduct of business rules and it will reshape the FSA policy of rule-use including the design of the FSA New COB Sourcebook. This chapter overviewed some of the key changes that will be introduced in accordance to the Directive’s stipulations with respect to client classification, client communication, product disclosure, conflicts of interest, best execution and appropriateness. The impact of MiFID on the Authority’s policy of rule-use will be discussed towards the end of Chapter Three, where the latest phase of the FSA policy of rule-use will be considered in detail. At present my priority is to describe how the policy of rule-use in financial regulation evolved, and this will be the objective of the remainder of Part I.
CHAPTER TWO

The Evolving Regulatory Policy of Rule-Use: The Pre-FSMA Era

1. Introduction

The previous chapter focused on the rationale and subject matter of conduct of business regulation. This chapter and the next one are devoted to the historical evolution of the policy of rule-use in the UK financial regulation making special reference to the conduct of business regime.1

The first seeds of controlling the conduct of investment business root back to the era of self-regulation2 and the first statutory attempts to eliminate fraudulent and deceitful behaviour in the securities industry3. This chapter, however, starts the discussion from a later stage namely, the era launched by the Financial Services Act 1986, as we cannot literally speak of ‘regulatory policy of rule-use’ with respect to the regulation of investment activities

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1 A definition of the term “policy of rule use” is provided above at pages 13 to 14, and note 7 of the Introduction.


3 Prior to the FSA 1986, there was a clear tradition of self-regulation. The incidence of regulation was fragmented and its legal underpinnings rudimentary. While legal restrictions were few, strict de facto segregation of the various sub-industries was ensured by means of cartel-like arrangements and restrictions on the membership of organised markets. I. MacNeil, ‘The Future for Financial Regulation: The Financial Services and Markets Bill’, 62 Modern Law Review (1999), 725 at 726.

3 With regard to statutes, of particular importance was the Prevention of Fraud (Investments) Act 1939 as amended in 1958. With regard to codes, of particular importance was the Code of Conduct formulated by the London Stock Exchange. L. C. B., Gower, ““Big Bang” and the City Regulation’, 51 Modern Law Review (1988), 1 at 6.
before the middle 80’s. Indeed, the question of how to model and use rules became a conscious policy concern only after the upheavals of the Big Bang in the City of London and the institutional reform they precipitated. Before that, the perceived advantages of self-regulation were by and large unquestioned.

The chapter is divided into two thematic areas. The first one discusses the legal framework and institutional structure of the financial regulation of that time. The second thematic area concerns the policy of rule-use making special reference to the design of the regulatory norms and the presence of self-regulatory elements. It explores the reasons for the detailed and complex nature of the SIB initial rulebooks, the factors underlying the restructuring of the rules, which occurred under the label of the New Settlement, and the developments in the policy of rule-use after the Large Report.

2. Legal framework and institutional structure

2.1. Market developments and institutional reform leading to the Financial Services Act 1986

Nearly thirty years ago securities regulation in the UK was primitive and investment activities were strictly self-regulated. Persuasion and other informal means of control was the norm. The Prevention of Fraud Act

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4 There were three separate streams of financial regulation: the regulation of investment activities, the regulation of banking activities and the regulation of a range of other activities which fell outside the scope of banking or investment as, for example, the activities of insurance companies, Lloyds and building societies. While the first two industries were self-regulated initially, the regulation of the third one was statutory based. My focus is on the regulation of investment activities only.

(Investments) 1958 was the main legal instrument that provided a framework for regulation. This was coupled with a myriad of rules and regulations that were made under this Act or produced by self-regulatory bodies like the London Stock Exchange (LSE), the Panel on Takeovers and Mergers and the Council of the Securities Industry. Despite the fact that it had no specific mandate over the securities industry, the Bank of England was perhaps the most important player in this informal scheme of regulation in the sense that it was entrusted with a range of key tasks as, for instance, to initiate the Panel of Takeovers and supervise the creation of other self-regulatory groups.

By the end of the 70’s this regime was becoming increasingly obsolete and inadequate in regulating investment transactions. Self-regulation operated like a club-like arrangement whose main objective was the protection of its members against competition, rather than keeping market ethos high by way of standard setting, monitoring of compliance and enforcement. In this connection, the case of the London Stock Exchange (LSE) –the most prominent association in the securities industry at that time- is of particular interest. LSE imposed a number of restrictions and protective measures for its members. Its rules prohibited outside companies to obtain any substantial financial interest in its members. In addition, it did not allow the undertaking of investment activities by firms operating in the form of limited companies and required firms to always act in a single capacity - either as market makers trading as principals (“jobbers”) or as a brokers trading as agents. Moreover, LSE rules prescribed a fixed minimum

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6 The Prevention of Fraud (Investments) Act 1958, like its predecessor 1939 Act, was concerned with the regulation of activities of ‘fridge stock’ and share dealers. Respectable firms, as for example, stockbrokers who were members of the London Stock Exchange, were not subject to this regime. B Rider, C. Abrams and M. Ashe, Guide to Financial Services Regulation, 6-7; and above, Page and Ferguson, 225.


commission. This protectionist regime dominated the securities market landscape in an era of significant transformation in financial markets both domestically as well as internationally (especially in the USA and Japan). Yet, it was a matter of time for the UK market to open up to these developments. Despite the hostile environment for foreign firms, the City of London continued to attract business from all over the world due to the Eurobond market.  

In 1979 the Conservative Government took a number of courageous measures that meant to change the UK financial market forever. The most decisive of all was the choice to refer the LSE Rule Book to the Restrictive Practices Court. This instigated a ponderous judicial procedure, which made clear that anti-competitive practices would no longer be tolerated. Since the proceedings in the judicial tribunal proved lengthy and cumbersome the government officials started parallel negotiations with the LSE hoping to persuade it to amend the Rule Book. In July 1983 these negotiations brought fruits. LSE agreed to recommend to its members the amendment of the Rules on condition that legislation would be introduced exempting the Stock Exchange from the Restrictive Trade Practices Act (Stock Exchange) 1984. Meanwhile, LSE had already abolished exchange controls and had relaxed the rules of membership so that member firms were allowed to incorporate outside interests up to 30 per cent. Reform did not stop there. Fixed commissions were brought to an end and the scope of application of the

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10 Rider et al., above note 6, 12-13.
11 The reference to the Restrictive Trade Practices Court was mainly concerned with the following three issues: minimum commissions, separation of capacity and access to membership. Above, 23-26.
12 On the reforms that took place see, generally, Above note 3, 1; and J. Littlewood, The Stockmarket, Fifty Years of Capitalism at Work (1998), ch. 27.
single capacity rule was trimmed down. Moreover, the London Stock Exchange changed its constitution to reflect the de facto changes in the composition of its membership. It was no longer an unregistered Deed of Settlements company but it became a registered limited company named “The International Stock Exchange of the United Kingdom and Republic of Ireland Ltd.”

Overall the regulatory reform facilitated the transformation of the UK financial markets. It precipitated the breaking down of barriers, which had started with the abolition of exchange controls. It created favourable conditions for the emergence of well-capitalised financial conglomerates, it unified the formerly divided domestic and international markets and eventually placed the City of London among the top three major financial centres in the world. Nevertheless, things were far from ideal. The dramatic transformation of UK firms into wholly owned subsidiaries exposed the weaknesses of the indigenous financial services industry. Furthermore, it caused a wide spread disillusionment as to the actual robustness of the traditional system of self-regulation and triggered scepticism about its expediency. At the same time, the deregulatory developments of the Conservative government eroded public confidence. This was the result of a massive increase in conflicts of interest and market abuse, which led to the proliferation of financial scandals. It should not be a surprise therefore why in early 80’s there was a cry for investor protection and a strong demand for effective regulation. The launch of the Financial Services Act 1986, to which I turn next, was the response to this call.

13 Above note 3, 4-5.
14 This was the result of further reform that took place between July 1983 and the Big Bang Day, which led to the introduction of a new method of marketing gilts, the revision of the equity market rules and the constitutional reform of the London Stock Exchange.
2.2. The Financial Services Act 1986

The aim of this section is not a detailed analysis of all the provisions of the Financial Services Act 1986 (the “Act” or “FSA 1986”). Its purpose is to highlight the subject matter and scope of application of the Act and overview the system of regulation that was put in place. The Financial Services Act 1986 emerged from the Gower Review.\(^\text{17}\) It was the product of intensive lobbying from the financial services industry and consumer interest-groups.\(^\text{18}\) The Act introduced a system of “self regulation within a statutory framework” or as more accurately Professor Gower prefers to describe it “statutory regulation monitored by self-regulatory organisations recognised by and under the surveillance of a self-standing Commission.”\(^\text{19}\)

This regime marked a significant departure from the club-like structure that flourished before. Nevertheless, in the early days of the Act, its self-regulatory aspect was extolled so that to make it easier for the financial services community to consent to the dramatic shift away from the informal regulatory arrangements that prevailed up till then.

The FSA 1986 replaced the Prevention of Fraud Act 1958. In many respects it had a broader scope of application.\(^\text{20}\) The FSA 1986 defined the term “investments” in such a manner so that securities, underwriting corporate


\(^\text{20}\) For example, it covered for the first time the provision of products such as personal pensions and life assurance. Above note 3, 18-20.
finance and investment management business came, to a greater or lesser
degree, within its remit.\textsuperscript{21} Deposit taking and lending activities were
excluded and were regulated under the Banking Act 1987.\textsuperscript{22} At the core of
the system was the requirement that those operating in the investment
industry must be authorised.\textsuperscript{23} Carrying on of investment business in the UK
without authorisation was a criminal offence.\textsuperscript{24} The 1986 Act also set out the
legal framework for the establishment of the Securities and Investment
Board (SIB) -a “designated agency” which would be chiefly responsible for
the regulation of financial markets- and the creation of Self-Regulatory
Organisations (as well as other self-regulated agencies) which would
transplant vital self-regulatory elements into the FSA 1986 regulatory
regime. Special provisions dealt with the dissemination of jurisdictional
competencies, the exercise of supervisory, rule-making and enforcement
powers as well as issues of accountability and judicial review.\textsuperscript{25}

The FSA 1986 introduced a system of self-regulation under a statutory
framework.\textsuperscript{26} This was grounded on hybrid institutional forms, which
combined state and private elements and which took the shape of a multi-
tiered regulatory structure. Specifically, securities regulation consisted of
three regulatory levels: At the top (governmental level) were the Treasury
and the Office of Fair Trading and Industry.\textsuperscript{27} At the middle was SIB and at

\textsuperscript{21} Above note 19. On the broad definition of “investment” see, R. White, ‘The Review of Investor
the Act’s definition of collective investment schemes.

\textsuperscript{22} Banking activities were regulated by the Bank of England under the new Banking Act 1987. See also
Financial Services Act 1986, Schedules 1 and 5. In addition, the Bank of England issued the London Code
of Conduct, which set out principles governing conduct of business with clients in order to ensure that
proper standards of integrity and fair dealing were observed.

\textsuperscript{23} This was similar to the licensing requirement under the Prevention of Fraud (Investments) Act 1958.

\textsuperscript{24} Another form of authorisation was, for example, the granting of licence for the provision of consumer
credit under the Consumer Credit Act 1974.

\textsuperscript{25} I discuss these provisions below.

\textsuperscript{26} Rider et al, above note 6, 38.

\textsuperscript{27} The Office of Fair Trading and Industry exercised certain enforcement powers jointly with the Securities
and Investment Board (SIB). A number of other governmental and quasi-governmental institutions were
also involved in the regulation of financial markets. Alongside the Bank of England were the Building
the bottom (the “practitioner level”) were the Self-Regulatory Organisations (SROs), Regulated Professional Bodies (RPBs), Exchanges and Clearing Houses.\(^{28}\)

With respect to investor protection and conduct of business regulation, the FSA 1986 contained provisions that introduced marketing restrictions of general application such as restrictions on uninvited telephone calls and personal visits (so called ‘cold-calling’), and restrictions on the issue of investment advertisements in the UK.\(^{29}\) In addition, organisations that were interested to receive recognition as SRO’s were required to demonstrate that they provided investor protection equivalent to that afforded by SIB. Investor protection were further reinforced by section 62 of the FSA 1986, which provided for a private right of action for those aggrieved as a result of breach of rules made under the 1986 Act.\(^{30}\) Certain aspects of the FSA 1986 –particularly the statutory provisions on the regulatory structure and rulemaking- had an immediate impact on the shaping of the policy of the rule-use of the time. These are discussed below.

### 2.3. The SIB, the SROs and the production of rules

Originally the 1986 Act did not entrust SIB with the regulation of financial markets. Legislative, investigative and enforcement powers were given to the Secretary of State for the Trade and Industry. The Act only enabled the Secretary of State –if he wished to- to delegate the majority of his powers to

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Societies Commission, the Registry of Friendly Societies and the Occupational Pensions Board. See A. Page, and R. Ferguson, above note 5, 88-90.

\(^{28}\) Above, 95-99.

\(^{29}\) For a general discussion of the FSA 1986 Conduct of Business regime see above note 6, Rider \textit{et al}, ch. 5.

\(^{30}\) The idea behind the provision of a private right of action was to encourage compliance. Nevertheless, there were voices expressing concerns that section 62 might cause an unprecedented waive of litigation. The availability of a private right of action had a significant impact on the way in which the policy of rule-use was subsequently evolved.
a “designated agency” provided that certain statutory conditions were met. These concerned the agency’s organisational structure, Board membership, monitoring and enforcement complaints, disciplinary procedures, and rule-making function. Specifically, SIB had to satisfy the following requirements. First of all, its chairman and other members of its governing body had to be appointed by the Secretary of State acting jointly with the Governor of the Bank of England. In addition, SIB was expected to make sure that its rules complied with the principles set out in Schedule 8 of the Act and that its Rulebook afforded investors a degree of protection that was equivalent to that provided under SIB rules. Moreover, SIB was under the obligation to consult publicly and ensure that the impact of its measures on competition was commensurate to considerations of investor protection. Finally, SIB was required to put in place a satisfactory system of monitoring and enforcing compliance, and more generally to be willing and able to promote high standards of integrity and fair dealing in the conduct of investment business.

SIB achieved the status of the designated agency in May 1987. As a result the following functions were conferred to it: (a) the responsibility to establish a new and comprehensive system for the regulation of investment business, based on the recognition and subsequent supervision and monitoring of self-regulating organisations, professional bodies, investment exchanges and clearing houses; (b) the power to produce rules; (c) the power

32 Until 1989, this was subject to approval by the Parliament. See, FSA 1986 s. 114 (11). Responsibility for the Act was transferred to the Treasury in 1992.
33 FSA 1986, s.114 and Schs.7 and 8.
34 In this manner government control over SIB was secured.
35 FSA 1986, section 114 (9) (b).
36 FSA 1986, Schedule 8 para. 12. Before the insertion of Schedule 7 para. 2A by the Companies Act 1989, SIB was under no statutory obligation to take into consideration the costs of rule-making.
37 FSA 1986, Schedule 7 paras. 3, 4 and 5.
to give authorisation to carrying on investment business to those firms that chose to be directly regulated by SIB; (d) powers of enforcement and intervention;\textsuperscript{39} and finally (e) the power to authorise and recognise investment schemes, as well as administer the provisions of the Act relating to such schemes.\textsuperscript{40}

The organisational structure of SIB was a peculiar constitutional hybrid combining both private and public elements. SIB was a company limited by guarantee. Its costs were borne by practitioners, except for the residuary cost of the Department and the new Tribunal, which was covered by the public budget.\textsuperscript{41} Thus, SIB could use its fee income to improve its services without having to confront limitations coming from staff establishments or civil service salary scale. Arguably, this gave SIB greater independence and flexibility and enabled it to recruit the nucleus of a first class staff.

Various arrangements ensured the accountability of SIB.\textsuperscript{42} The FSA 1986 required that the composition of its Board had to reflect a proper balance of interests between the industry and the public at large.\textsuperscript{43} The Secretary of State had the right to appoint the Chairman and other members of the Board as well as the power to remove, dismiss or replace them.\textsuperscript{44} In this manner, SIB was answerable to the Secretary of State and through the Secretary of State to the Parliament. Moreover, SIB was expected to submit an annual report to the Secretary of State, a copy of which had to be

\textsuperscript{39} Including powers to seek injunctions and restitution orders, to issue disqualification directions, to discipline directly regulated firms and institute criminal proceedings.
\textsuperscript{40} A. Page and R. Ferguson, above note 5, 90-91.
\textsuperscript{41} It also carried the symbolism that the industry would continue to be actively involved in the regulatory system. Above note 5, 91.
\textsuperscript{42} On issues of accountability see, generally, above note 7.
\textsuperscript{43} FSA 1986, Sch.7 para.1(2) and Sch.7 para.1(3). Nonetheless, the initial appointment of the SIB members was made by the Bank of England. J. Black, above note 31, at 67.
\textsuperscript{44} FSA 1986, section 115. The power to remove the delegated powers was meant to work as a deterrent. A less radical measure was provided by FSA 1986, Schedule 7 para 1 (2) by virtue of which the Chairman and the other members of the governing body of SIB were appointed by the Secretary of State acting together with the Governor of the Bank of England.
submitted in Parliament.\textsuperscript{45} Finally, SIB was subject to judicial review while the FSA made special provision for the Financial Services Tribunal, a judicial body with power to review the exercise of certain of SIB’s powers.\textsuperscript{46}

The impact of SIB regulation on competition received special attention. Specifically, the 1986 Act required the Chancellor to consult with the Director General of Fair Trading\textsuperscript{47} and gave him the power to demand the amendment of the rules where rules were thought to be anti-competitive.\textsuperscript{48} In addition, the Director General had the continuous duty to review SIB rules and their effects on competition.\textsuperscript{49} The Chancellor, who was charged with the task to ensure that SIB provided the desired level of investor protection, was not furnished with similar power to order the alteration or revocation of rules. The only thing, that the Chancellor could do, was to resume any of the transferred functions in whole or in part.\textsuperscript{50} This was a radical measure and the intention was only to deploy the threat of it in order to discipline and manipulate the workings of SIB.

To perform its role, SIB was vested with a multitude of enforcement powers.\textsuperscript{51} It could require information and its investigation powers were similar to those of the Department of Trade and Industry.\textsuperscript{52} SIB was also allowed to apply to court for a restitution order\textsuperscript{53} or an injunction in order

\textsuperscript{45} In addition, the Secretary of State was vested with the power to give directions to SIB with respect to its accounts and audits. FSA 1986, section 117. J. Black, above note 31, 67.


\textsuperscript{47} FSA 1986, ss. 119 and 122. In 1992 the responsibility for supervising the financial services regulation was transferred to the Treasury.

\textsuperscript{48} FSA 1986, ss. 119 and 122. J. Black above note 31, 67-68.

\textsuperscript{49} FSA 1986, s. 122.

\textsuperscript{50} FSA 1986, s.115.

\textsuperscript{51} Above note 6, Rider et al, 388-402.

\textsuperscript{52} FSA, 1986, ss.104, 95, 105 and 106. See further, J. Black, above note 31, 73-74.

\textsuperscript{53} FSA 1986, s.61.
to prevent breach of its own rules or those of SROs. Moreover, SIB had the power to issue disqualification directions, the effect of which was the prohibition of employment of a particular person, as well as to make public statements as to a person’s misconduct.

SIB stand at the top of the hierarchical structure yet, it was not alone in regulating the carrying out of investment activities. The FSA 1986 provided for Self-Regulatory Organisations (SROs), which were intended to supplement and in certain respects reinforce the operation of SIB. SROs were organised on functional basis. Apart from being the primary route to authorisation, SROs made their own rules, monitor compliance and could even take enforcement action. Interestingly enough, the 1986 Act did not vest enforcement powers with SROs. It was the contract of membership that enabled SROs to enforce their rules and regulations. Nevertheless, enforcement action was subject to judicial review.

A body or association, that wished to operate as Self-Regulatory Organisation, had to be “recognised”. To this effect, it was expected to

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54 FSA 1986, s.61; SIB’s power to issue and enforce rules or guidance against members of SROs was discussed in R v. Securities and Investment Board & Anor. Ex p. Independent Financial Advisers Association & Anor. [1995] CLC, p.872.
55 FSA 1986, s.59 and s.60.
56 FSA 1986, section 7 (1). Investment exchanges and clearing houses were not treated as SROs. They were granted certain privileges, provided that they become recognised by SIB. FSA, 1986 ss. 36-41. A. Page and R. Ferguson, above note 5, 92-96. Major firms of solicitors or accountants were called Recognised Professional Bodies. FSA 1986, ss.15-21 and Schedule 3.
57 According to FSA 1986 Schedule 2, SIB was under the duty to grant recognition on condition that it was satisfied that SROs’ rules provided investor protection at least as effective as the regulation of SIB. Once the recognition was granted investment firms had the option either to become members of a SRO or become directly subject to the regulation of SIB.
58 The organisation and number of SROs were not prescribed in the Act. See, L. C. B. Gower, Review of Investor Protection, Discussion Document (1982); R. White, above note 21, at 558; and J. Black above note 31, 69.
59 On the authorisation regime under the FSA 1986 see B. Rider et al, above note 6, ch. 3.
60 The rule making powers of SROs is discussed below.
62 B. Rider, et al, note 6, 42.
satisfy certain statutory requirements\textsuperscript{64} as, for example, the requirement to have in place “adequate arrangements” and resources for monitoring compliance and enforcement,\textsuperscript{65} the requirement to ensure that members were “fit and proper” persons to carry on investment business of the kind with which the self-regulatory organisation was concerned\textsuperscript{66} and the requirement that a proper balance was maintained among the interests of its members and between the interests of the organisation and the interests of the public.\textsuperscript{67} In recognising a self-regulatory body, SIB’s chief concern was to create a comprehensive system of SRO’s capable of providing authorisation to all potential investment business and to keep their number as limited as possible, given that their proliferation would make supervision more difficult.\textsuperscript{68} SIB’s role did not end once SROs were granted recognition. SIB had a continuous duty to ensure that SROs observed statutory requirements at all times by monitoring their performance and imposing sanctions where necessary.\textsuperscript{69}

Originally seven, SROs merged into five, and latter on into three bodies, namely: (a) the Securities and Futures Authority (SFA, formed in 1991 by the merger of the Securities Association and the Association of Future Brokers and Dealers); (b) the Investment Management Regulatory Organisation (IMRO); and; (c) the Personal Investment Authority (PIA, formed by the merger of the Financial Intermediaries, Managers and Brokers Regulatory Association and the Life Assurance and Unit Trusts Regulatory Organisation). The names of these organisations were broadly

\textsuperscript{64} For a discussion on the criteria for recognition and instances of complete or partial revocation of authorisation see, B. Rider, \textit{et al}, above note 6, 39–41.

\textsuperscript{65} FSA 1986, Sch.2 paras 4, 6 and 7 (SROs), Sch.3 (RPBs), Sch.4 (RIEs) and s. 39 (RCHs). SROs did not enjoy investigative powers similar to those of SIB. However, SIB could delegate some of them by virtue of section 105 of FSA 1986. Perhaps the most important powers that were given to SROs were the power to present a petition for an administration order against a member and the power to block SIB’s enforcement action in certain circumstances. On that see ss. 74 and 72(5), FSA 1986.

\textsuperscript{66} FSA 1986, Sch2 para.5. See further, J. Black, above note 31 at 71.

\textsuperscript{67} FSA 1986, Sch.5 para.5 and Sch.3 para. 4(5).

\textsuperscript{68} A. Page and R. B. Ferguson, above note 6, 93.

\textsuperscript{69} FSA 1986, section 12 and section 13 (2). J. Black, above note 31, 71.
The incorporation of SROs into the institutional structure of financial regulation was expected to bring about a number of advantages. These included the channelling of practitioner input into the regulatory system, the enhancement of compliance levels and the conduct of the day-to-day regulation in a manner that would keep the industry happy and willing to cooperate.\textsuperscript{71}

The relationship between SIB and SROs deserves special attention. As it was noted already, SIB’s mandate was not exhausted in the regulation of investment activities. It was in addition responsible for the supervision of SROs. This allowed SIB to act as a buffer between SROs and the political process.\textsuperscript{72} Specifically, SIB monitored the rules and practices of the SROs and had to make sure that they provided investor protection to the level that satisfied the statutory “equivalence test”. To assess this, SIB had to take into consideration the nature of the investment business, the nature of the investors and the effectiveness of the organisation’s enforcement arrangements.\textsuperscript{73} However, monitoring of compliance used to take place through a series of self-assessment exercises undertaken by the SROs and then sent to SIB. At first sight, this was regrettable because, it meant that SIB was not able to assess in any reliable manner the amount and quality of information it received; obviously this was under the exclusive control of the assessed SROs. The monitoring process was further undermined by the fact that SIB had no other powers apart from refusing recognition to an SRO. For example, SIB could not ask those who applied for membership through it to opt for an SRO. Nor could it force SROs to redefine their area

\textsuperscript{70} Most banks that were engaged in investment business under the FSA 1986 had to get authorisation from the SFA, IMRO and/or PIA.
\textsuperscript{71} Above note 3, 14; note 7, 144-148; and R. White, note 21, at 559.
\textsuperscript{72} A. Page and R. Ferguson, above note 5, 95.
\textsuperscript{73} See, FSA 1986, Sch.2 para.3 and Sch.3 para.3 as amended by s. 203 of the Companies Act 1989. J. Black, above note 31, at 72.
of regulation in the absence of a breach of the recognition requirements. Suspicous as this lenience might seem, it was grounded on the concern that a stricter approach would suffocate the autonomy of SROs and erode public confidence as to the Government’s commitment to preserve self-regulation.

Rule-making powers were shared between SIB and SROs. The Financial Services Act 1986 required the promulgation of rules and regulation, which would address a variety of issues. Broadly speaking these regulatory requirements aimed at making sure that persons were fit and proper to undertake investment business, that firms complied with conduct of business and client’s money rules, and that firms provided their clients with known and appropriate channels of complaint. Furthermore, they provided for a compensation fund for clients in the event of the firm’s insolvency and offences were detected and duly prosecuted.

By virtue of its rule-making powers, SIB produced a set of regulatory requirements governing the firm’s conduct of business. These included rules establishing disclosure requirements, controlling excessive charging and churning, requiring due care skill and diligence, fairness between customers, Chinese walls, customer agreement, cancellation rights, and unsolicited calls. Alongside this, SIB promulgated notification regulations, indemnity rules and rules making provision for a compensation fund. In performing its rule-making function, SIB was under the duty to publish its proposed rules, together with a statement inviting representations within a

74 This relationship later on changed. On that see discussion below.
75 See, for example, 1985/6 HC Standing Committee E, cc. 227-228 and cc.303-306.
77 Above note 3, 17.
78 B. Rider et al, above note 6, 103-116.
79 FSA 1986, ss. 48, 49, 55, 48, 51, 56, 52, 53 and 54 respectively.
specified period of time. However, there was no equivalent duty to consult the Chancellor or seek his approval or to pay due regard to the costs and benefits of the promulgated rules. SIB was only expected to meet the competition requirements set out in the Act. SROs’ rule-making powers ran in parallel with those of SIB. Similarly to SIB, SROs were under the duty to consult with their members, but the exercise of SROs’ rule-making powers was not directly subject to competition scrutiny. Suffice was that SROs rules provided investor protection equivalent to that of SIB.

In principle, SIB rules were applicable only to those firms that were authorised directly by SIB, while SRO rules were applicable only to SRO members. In practice, this was subject to exceptions. For example, indemnity rules were applied to members of SROs only at the body’s request, whilst rules concerning the compensation fund applied only to SROs after consultation with them. Similarly, the FSA 1986 established a special regime for client money, unsolicited calls and cancellation rules. These rules were applicable to all authorised persons unless SROs had already made rules dealing with these issues. In any case the extension of the scope of application of SIB rules aimed at filling regulatory gaps and was generally justified in the name of investor protection.

3. The regulatory policy of rule use

3.1. Introduction

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80 This was subject to exception where delay would harm the interests of investors. FSA 1986, Schedule 9, para 12(1) and para 13 (2). See further, J. Black above note 31, 76-77.
81 B. Rider et al, above note 6, 117-118.
82 Strangely enough the FSA 1986 was explicit only in relation to client money and unsolicited calls. With respect to cancellation the letter of the Act was silent. J. Black, above note 31, 74.
So far the discussion centred on the market developments and the institutional organisation of financial regulation nearly twenty years before the enactment of the Financial Services and Market Act 2000. In this section, the focus of attention turns on the nature of the policy of rule use of that time. Particular emphasis will be placed on the design of the rules, as well as the self-regulatory features that served to operationalise their formation, application and enforcement. It will be argued that the use of rules as a policy concern evolved into three subsequent stages: The initial Conduct of Business Rule Book, the New Settlement which created a more sophisticated three-tier system of rules and the Large Report, which brought about a series of substantial improvements and set the foundations for further reform. These marked a dramatic shift away from self-regulation and other traditional patterns of rule-use, which found its full expression only recently.

3.2. The initial rules

The initial conduct of business rules contained in the 1987 SIB Conduct of Business Rulebook, a piece of secondary legislation that was produced by virtue of the Financial Services Act 1986. These were formulated by the Marketing and Investment Board Committee (MIOBOC), which subsequently submerged with SIB, and were the outcome of endless debates between the regulator and the Office of Fair Trading (OFT).

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83 Here my focus is on rule-design. The substantive aspect of the SIB and SRO rules governing conduct of business will not be considered. In this relation, suffice is to point out that by and large they dealt with similar issues to those of the present FSA Conduct of Business regime as, for example, “cold calling”, client money, due skill care and diligence, information disclosure, Chinese walls, customer agreement, and cancellation rights. See B. Rider et al, above note 6, ch.6.

84 This is the subject of extensive discussion in the next chapter.

85 SROs created their own conduct of business rulebooks, which supplemented the rules contained in the SIB rulebook. Although these were different in approach and detail they were nevertheless linked by the equivalence test and reflected the standards of investor protection that were inherent in SIB rules. B. Rider et al, above note 6, 117-118.

86 The rules governing conduct of business were only one of the eight sets of rules, which SIB had to produce before it could meet the statutory criteria, as a “designated authority”. J. Black above note 31, 83.
In terms of their design, the provisions of the Rulebook followed by and large a standardised pattern with the dominant style being that of a general statement or provision followed by a long list of exceptions.\textsuperscript{87} This feature did not make the Rulebook an easy to ready text. As a matter of fact the provisions of the initial Rulebook were far more detailed and complex than it had been anticipated.\textsuperscript{88} Most of the provisions and particularly those setting out information to be contained in documents were highly detailed, specific and precise. Furthermore, complexity dominated the design of the initial Rulebooks due to the presence of long definitions, the frequent use of cross-references to other rules and the fact that rules were subject to constant amendments introducing substantive changes to the rules, their requirements or scope. At this stage no special care was taken to improve the navigability and user-friendliness of the Rulebooks.

Despite the fact that the 1986 Act provided for the possibility of drafting rules in the form of guidance, SIB did not make use of this option.\textsuperscript{89} Guidance would have been a flexible tool for SIB to advise SROs in their rule making function and indeed invaluable in light of their duty to provide investor protection at least equivalent to that of SIB. However, for reasons that will be explained in more detail below, both DTI and SIB felt that it was expedient not to take advantage of this possibility and rely exclusively on legally binding prescriptive requirements.\textsuperscript{90} Guidance was not the only form of regulatory provisions that was absent in the initial conduct of business rulebook. Regulatory provisions written in high level of abstractness and occupying a distinct place in the Rulebook were also

\textsuperscript{87} J. Black, above note 31, 91. My focus is on the SIB Rulebook as at this preliminary stage SRO’s enjoyed hardly any scope of deviating from SIB’s stipulations. This was due to a number of factors, which are discussed below.

\textsuperscript{88} Above, 84-85.

\textsuperscript{89} FSA 1986, section 114(10), (11) and (12).

\textsuperscript{90} See the discussion below.
At this early stage, it was thought that the preservation of self-regulatory elements into the organisational structure of financial regulation was enough to ensure flexibility where this was necessary and overall deal with problems like under-inclusiveness and interpretive ambiguities.

The operation of SROs was expected to add two crucial dimensions in the policy of rule-use. The first one was the presence of various communities of interpreters, which played a significant role in the interpretation and subsequent application and enforcement of regulatory norms. Specifically, the members of each SRO were supposed to do something more than merely share information relevant to the interpretation of rules. They were expected to share a certain market ethos and develop a common understanding of it. Furthermore, the community of interpreters was expected to impose a sort of psychological pressure upon its members to abide by the accepted norms. This suggests that despite appearances to the contrary, the policy of rule use was not of the kind that one encounters in a conventional “command and control” regime. It was unique in the sense that the attempt was made to preserve at least to some degree practitioner involvement and to deploy informal means to encourage compliance.

Schedule 8 of the Financial Services Act contained a list of principles that were applicable to SIB’s rules and regulation. This provision bears similarities with the Financial Services Authority eleven principles for business. The fact, however, that it was incorporated in the Act signifies major differences between the two regimes. Not only did their production remain in the exclusive jurisdiction of the UK Parliament but also, SIB was intended to be their sole recipient. Schedule 8 of the Financial Services Act 1986 was not directly binding for the regulated population.

Julia Black calls this collective enterprise “interpretive community”. I use the term “community of interpreters” to avoid any unnecessary association with Stanley Fish’s thesis on interpretive communities. The notion of “interpretive communities” is further analysed in Chapters Four and Five below. The impact of SRO’s on the policy of rule-use is further discussed in J. Black note 31, 81-83.

With the entry of new members into the various SROs and the rapid transformation of the marketplace it became increasingly difficult for these communities of interpreters to preserve all those things that had in common. Therefore, their potential progressively faded away and restored only after the Large Report. See discussion below.

The second dimension that the presence of SROs was to supposed to affix into the policy of rule use was the adoption of a communicative style of regulation, namely a process of rule formation, application and enforcement that was essentially dialectical and which facilitated the modification and refinement of regulatory requirements on ad hoc basis.\textsuperscript{95} SROs were supposed to ensure that the production of rules would be the outcome of consultation and input coming directly from the industry. SROs were deemed to operate as direct sensors of market developments and, consequently, as a reliable source of recommendations about the need to qualify certain rules, clarify them or otherwise amplify their content.\textsuperscript{96} Moreover, by facilitating the flow of information, SROs were expected to boost compliance levels, so that enforcement officials would not have to rely exclusively on the uncertain success of frequently cumbersome enforcement practices.\textsuperscript{97}

The communicative elements were not confined within the jurisdictional perimeter of SROs. The workings of SIB were also dialectical at least to the extent in which they entailed the flourishing of an on-going communication leading to the clarification or refinement of regulatory requirements. For instance, the list of FSA requirements that SROs had to meet in order to gain recognition by SIB –particularly, the equivalence test- generated an occasion for conversation between SIB and SROs whose aim was to help SIB assess their capacity to provide the prescribed level of investor protection.\textsuperscript{98} By the same token statutory provisions, which empowered the

\textsuperscript{95} The notion of conversational regulation is discussed in J. Black, “Talking about Regulation”, Public Law (1998), 77-105.

\textsuperscript{96} Frequent amendments to the rules due to reconsiderations, requests or exemptions served exactly this purpose.

\textsuperscript{97} In light of the prescriptive and detailed regime of the initial SIB rulebook the conversational elements performed poorly.

\textsuperscript{98} FSA 1986, Schedule 2 (requirements for recognition) and section 114 (9)(b) (equivalence test, which was later on replaced with the adequacy test by virtue of Companies Act 1989, section 203).
Secretary of State to modify rules\textsuperscript{99} or grant indemnity orders\textsuperscript{100} as well as statutory provisions, which vested SIB with a similar power to alter SRO rules, were expected to have the same result, namely to create fruitful conditions for the realisation of a communicative style of regulation.\textsuperscript{101}

To sum up, at this early stage of evolution the policy of rule-use was a peculiar mixture of detailed and prescriptive rules and of self-regulatory elements, which were manifested in the presence of communities of interpreters and the adoption of a communicative style of regulation. The design of rules was soon to change. Progressively, detailed and prescriptive rules gave way to statements of principle namely, regulatory provisions termed in high level of abstractness and generality. Similarly, self-regulation was gradually downplayed and by the time of the introduction of the Financial Services and Market Act 2000, it faded away. However, the same did not happen with respect to the communities of interpreters and the conversational dimension of the policy of rule-use. Below I discuss the factors that urged the initial appetite for precision and detail, explore the reasons that led to its decay and how the departure from a regime that was essentially legalistic ironically opened the way to the adoption of a more sophisticated approach in the policy of rule-use where emphasis was placed on interpretation rather than the design of rules per se.

3.3. Factors that influenced the production of detailed rules and the preservation of self-regulatory elements

Two were the dominant characteristics of the policy of rule-use during the short life of the initial SIB conduct of business rulebook and the respective

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{99} FSA 1986, section 50 (1) and (2).
\item \textsuperscript{100} FSA 1986, section 53.
\item \textsuperscript{101} FSA 1986, section 13.
\end{enumerate}
\end{footnotesize}
SROs’ conduct of business rules. In relation to the design of the regulatory norms emphasis was placed on detail and precision, while in relation to the procedural aspects of their formation, application and enforcement the preservation of self-regulatory elements was more than profound. This trend in the policy of rule-use was due to a range of factors including the flawed conceptualisation of the idea of certainty, the institutional structure of financial regulation, the lack of experience and forseeability and the regulators’ inability to appreciate the interaction between rule-design and the operationalisation of informal means of regulation.

Specifically, three policy considerations shaped the design of the SIB Rulebook:

“certainty: the need for firms to know what they must do, can do or cannot do; for customers to know what to expect and to what they are entitled; for the rules to be monitored effectively and efficiently; and for the sanctions under the Act whether discipline of firms or of individuals or redress by the courts for individuals who have suffered loss, to operate effectively;

consistency: the risk that rules drafted in general terms will be interpreted too diversely by different firms in a huge, competitive and diverse industry, penalising firms who take a strict interpretation and the customers of other firms;

standards: the difficulty, given a starting point of considerable variations in standards of competence and honesty, and given the

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102 I will refer to the SIB Rule Book because –as I will explain in a while- at that stage of evolution SROs had hardly any scope to exercise their discretion in producing their own conduct of business rules. The quite inflexible statutory “equivalence test” and a myriad of other unfavourable factors led SROs to essentially opt for a blind copying out of SIB’s regulatory requirements.
highly competitive environment, of assuming that without specific
guidance all firms will operate to the standards of the best."\textsuperscript{103}

These considerations suggest that SIB officials were apprehensive of the
new state of affairs that was beginning to emerge as a result of the
deteriorating homogeneity of market landscape in the City of London. They
thought that, in the absence of uniformity, a common understanding of
regulatory norms would be unattainable, and the possibility to foster
compliance by way of informal means would be dramatically limited.
Interpretive divergence threatened the success of the newly launched system
of financial regulation. Accordingly, it was paramount to deal with this
problem and the best way to do so was by producing rules that would allow
SIB to control the interpretive discretion of SROs and through them the
interpretive attitude of the regulated firms. To this end, it was thought that
rules had to be self-contained. Their literal reading should have been enough
to convey all the necessary information about what was acceptable and what
was non-acceptable behaviour, so that to preclude any scope of
manoeuvre.\textsuperscript{104}

The time of the drafting of the initial rulebook was an additional factor that
tipped the balance in favour of precision and against abstractness and
vagueness. The fact that SIB produced conduct of business rules before
gaining the status of the “designated agency” meant that the driving force
behind its rule-making strategy was to please DTI officials.\textsuperscript{105} The latter were
sceptical about the future performance of SIB. They sensed that they had a
unique opportunity to stir up regulatory developments at the level of SIB

\textsuperscript{103} SIB, \textit{The SIB Rulebook: An Overview} (Oct. 1987), para. 10 (emphasis provided); and J. Black, above note 31, 88.
\textsuperscript{104} This was consistent with the prevailing narrow interpretation of the idea of certainty. J. Black above
note 31, 88-89; and note 106, para.10.
\textsuperscript{105} J. Black, above note 31, 83-84.
and did the most of it by putting psychological pressure and setting strict interpretive boundaries to circumscribe SIB’s prospective exercise of discretion.\footnote{Apart from the power to challenge SIB’s rule-making in light of its impact on competition, DTI lacked any substantial power to force changes in SIB level.}

It was not difficult for DTI to persuade SIB about the need for detailed rules. SIB itself had its own reason to favour this prospect.\footnote{J. Black above note 31, 88-89.} With respect to SIB’s relationship with the various SROs, SIB was found in a similar position to that of DTI. It was part of SIB’s responsibility to make sure that SROs provided the desirable level of investor protection and detailed rules appeared to be a helpful tool to control SROs’ exercise of rule-making powers and assess—though in a rather mechanical manner—their capacity to protect investors up to the statutory standard that was captured in the “equivalence test”.

But even the wider political context militated in favour of legalism and precision.\footnote{Above, 90.} A number of scandals and fraud cases challenged public confidence as to the competence of self-regulation to deliver an appropriate level of investor protection. Therefore the demand for tough regulation was high at the time of the drafting of the initial Rule Books. To restore public trust, the architects of the regime made provision for a private right of action (section 62 of the FSA 1986).\footnote{On the rationale for the provision of a civil right of action, see A. Page and R. Ferguson, above note 5, 106-108; and B. Rider et al, note 6, 61-65.} This increased the pressure for legally binding and specific regulatory requirements, for, it was feared that abstract rules would encourage a litigious atmosphere.\footnote{Above.}

\footnote{106 \footnote{Apart from the power to challenge SIB’s rule-making in light of its impact on competition, DTI lacked any substantial power to force changes in SIB level.} 
107 \footnote{J. Black above note 31, 88-89.} 
108 \footnote{Above, 90.} 
109 \footnote{On the rationale for the provision of a civil right of action, see A. Page and R. Ferguson, above note 5, 106-108; and B. Rider et al, note 6, 61-65.} 
110 \footnote{Above.}
The emphasis on certainty and predictability that dominated the design of the initial SIB rulebook was supposed to be counterbalanced by the preservation of self-regulatory elements into the organisational structure of financial regulation. The incorporation of self-regulation into an otherwise purely “command and control” regime makes sense in light of the perceived advantages associated with the adoption of informal techniques of regulation.\textsuperscript{111} We should not lose sight of the fact however that the survival of self-regulatory practices under the FSA 1986 was a necessary compromise rather than a policy choice that was prescribed after careful consideration of its benefits. To put it differently, so much were bureaucratic officials obsessed with controlling each other’s interpretive discretion so that concerns about the flexibility, adaptability and cost efficiency of the policy of rule-use did not figure at the top of their priorities. At the early phase of evolution, self-regulation survived the birth of statutory regulation simply because and to the extent in which it was essential to secure the industry’s co-operation by keeping rebellion low.

3.4. Problems and further reform

The policy of rule-use that emerged out of the initial conduct of business Rulebooks did not last long. As soon as the DTI powers were delegated to SIB, the deficiencies of this regime became apparent and criticism against the complicated structure of the rulebooks started to gain ground.

The de-facto suffocation of self-regulatory elements was at the core of the problem.\textsuperscript{112} Not only were SROs excluded from the formation of the initial rules (at the time of their drafting Self-Regulatory Organisations did not officially exist) but they were also discouraged to deviate from SIB rules and

\textsuperscript{111} R. Baldwin and M. Cave, above note 2.
\textsuperscript{112} J. Black, above note 31, 88-89 and 93.
introduce their own special regime. SIB stipulations as to what would amount to adequate investor protection for the purposes of the Financial Services Act were so extensively detailed so that blind adherence to these directions was the only way to ensure that SROs ‘played safe’. Consequently, regulation failed to benefit from practitioners’ input in practice. The regulatory system was incapable of either adapting to the changing market environment or creating the necessary psychological conditions, which would promote optimal compliance without the need to resort to enforcement action.

The communicative style of regulation did not work either. Modifications and indemnities involved a burdensome procedure and there was no provision for post hoc review of decisions. The presence of a complex network of communication was a further downside. Communication was time consuming, informational failure was frequent and the whole process was too perplex to be transparent. Furthermore, interpretive communities were malfunctioning because SROs were not given the time to create bounds with their new members in order to cultivate a common understanding of the regulatory norms. Finally, the extensively detailed drafting of the 1987 Rulebooks induced the regulated firms to comply with the letter rather than the spirit of the rules. It was the culmination of all these difficulties that precipitated major changes in the policy of rule-use, which I discuss next.

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113 FSA 1986, Schedule 2 para. 3(1) as it was amended by Companies Act 1989, section 203. On the equivalence test see B. Rider et al, above note 6, 61; and, A. Page and R. Ferguson, note 5, 94.

114 For example, FSA 1986, section 50 provides a time consuming procedure for the modification of conduct of business rules.

115 This was the outcome of the complex institutional structure. The architects of the regime were not able to appreciate the actual difficulties involved in their attempt to combine self-regulation and statutory regulation within the same regulatory framework.

3.5. The New Settlement

The New Settlement was the official response to the persistent calls for reform. It was introduced by the Companies Act 1989, which changed the previous regulatory regime both in terms of substance and technical design. Specifically the Companies Act 1989 reformed financial regulation in the following respects: First of all, it restricted the private right of action under section 62 of the Financial Services Act 1986 only to a particular class of investors. Second, it extended the rule making power of SIB. Under the new regime, SIB was in a position to state regulatory principles, designate rules as directly applicable to members of the SROs and issue codes of practice. Third, it modified the criteria on the basis of which the competence of SROs was to be assessed. In particular, it substituted the requirement of ‘equivalent’ level of investor protection with the more lax requirement of ‘adequate’ investor protection. Finally, the Companies Act 1989 required that both SIB and SROs maintain the necessary arrangements that would make possible for them to assess the cost of compliance with their rules.

In terms of design, the New Settlement introduced a three-tier system of rules. The aim was to simplify and rationalise the drafting and wording of the rules and to re-establish the relationship between SIB and the various SROs. In particular the new Chairman of SIB, David Walker, envisaged a different role for regulation and rules, a role in which rules do not prescribe

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117 J. Black, above note 31, 75 and 92-93.
119 FSA 1986, section 47A (1), section 63A and section 63C introduced by the Companies Act 1989, Part VIII, section 192 (statements of principle), section 194 (designated rules and regulations) and section 195 (codes of practice) respectively.
120 Companies Act 1989, Part VIII, section 203 which amended FSA 1986, Schedule 2 para 3(1).
121 A. Page and R. Ferguson, above note 5, 94.
122 Companies Act 1989, Part VIII, section 204.
in detail what and how things should be done but only what ought to be done. In this spirit the 1988 Paper introduced a more elaborate definition of “self-regulation,” stressed the appropriateness of statements of principle in bringing about the desired policy outcomes, and set out a list of qualities that the design of the statements of principle had to concentrate on.

In relation to the definition of self-regulation, the regulated population was reminded that ‘self-regulation’ essentially meant “regulation of the self.” This implied that the management of each regulated firm had an essential role to play in maintaining a high corporate ethos. The regulatory policy of rule-use had to mirror the active role of senior management and facilitate the performance of the tasks that “the regulation of the self” entailed. Therefore, it was necessary to design regulatory provisions in such a manner so that to allow scope for manoeuvre. Making explicit reference to self-regulation was both expedient and symbolic. It was expedient because it made clear that the move towards more statute-based regulation did not intend either to discharge the regulated firms from their own responsibility to ensure adherence with regulatory requirements or to discourage them from adopting a critical attitude when deciding appropriate modes of action. Furthermore, the remark on self-regulation was symbolic because it purported to get the message across that, despite appearances to the contrary, the architects of the regime believed in the desirability of self-regulation and were keen to ensure that this would actually work.

124 J. Black above note 31, 103.
With respect to the design of the statements of principle, the New Approach recommended that these should have the following characteristics:\footnote{126}

“-consistency and cohesiveness in the standards applying, as a backbone which draws the rules together;
-intellectual rigour on the part of the regulators, in ensuring that the new requirements really are justified;
-practitioner understanding of and support for the provisions made;
-emphasis on the spirit, rather than the letter, of what is prescribed; and
-a dynamic quality in the rule books, enabling them to apply to new situations without constant reformulation.”

The New Approach signalled out a major change of mind in the policy of rule-use at least on paper. For the first time emphasis was placed on rules drafted in high level of abstractness and generality. Special care was taken to waive any doubt that the regulated firms had to do their own part in ensuring compliance with the spirit rather than the letter of the rules. Moreover, the role of SIB was refined. SIB was expected to distance itself from rulemaking. Its task now was to exercise leadership by setting standards and supervising their effective implementation and enforcement. To get a deeper understanding of the implications of the New Approach, below I will consider the design and structural inter-relation of the regulatory requirements that comprised the three-tier system of rules. The discussion will then pave the way to an exploration of the factors that made possible the materialisation of these developments. For the sake of clarity and comprehensiveness, some repetition will be inevitable. However, the effort has been made to keep this at minimum.

\footnote{126 Above note 123, 51 and J. Black above note 31, 101.}
3.6. Analysis of the three-tier system of rules

In the first tier of rules one finds the SIB Principles. These were drafted by SIB and characterised by a high level of generality. The shift from detailed rules to abstract rules was intended to give guidance to firms, to highlight the underlying policy objectives and overall promote compliance. Moreover, now that the management had a more essential role to play in maintaining a high corporate ethos, the Principles helped chief executives to identify a range of basic moral principles that had to govern the conduct of their business. A variety of drafting techniques was deployed in formulating the SIB Principles. For example, words such as ‘reasonable’, ‘proper’, ‘adequate’, ‘fair’ were incorporated to make the Principles appear vague and open-ended, whilst phrases and words that were in need for definition and further clarification were avoided.

The second tier comprised the Core Rules namely those rules, which SIB decided to designate as directly applicable to SRO members. The Core Rules were “the outcome of protracted negotiations between SIB and the SROs”. They were intended to provide a common core of regulatory provisions, containing the essential duties, which would apply to SRO members and, at the same time leave enough room for SROs to produce their own rulebooks. In this manner, it was thought, that the Core Rules would provide coherence in a way that was much less intrusive to the SROs

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127 The Principles came into effect in April 1990. These were largely derived from “the ninety-three principles contained in the New Approach, including the Introduction to the 1987 Rules and the principles set out in Schedule 8 of the FSA 1986”. J. Black above note 31, 100.
128 J. Black above note 31, 100-108.
130 J. Black above note 31, 105.
131 The only exception to that was the definition of the word “customer”. J. Black above note 31, 105-107.
133 J. Black above note 31, 109. The negotiating process was affected by a number of factors, notably the requirement for speed and the need to make sure that the Core Rules are kept brief and simple. They were eventually published in January 1991.
jurisdiction.\textsuperscript{134} Compared with the SIB Principles, the Core Rules were of intermediate generality. They were imprecise in the sense, that they neither contained a list of factors, which had to be considered or taken, nor did they indicate the manner in which some course of action should have been carried on. Other structural features that are worth mentioning were the provision of a glossary\textsuperscript{135} and the inclusion of derogations.\textsuperscript{136} While the glossary was employed as a drafting technique to ensure that the Core Rules were kept simple, brief and durable, the availability of derogations aimed at resolving the tension in SIB and SROs relationship that ensued from the direct application of the Core Rules to SROs’ members. Indeed, derogations were relied upon as a technique that would allow the creation of a common core of rules without undermining the industry’s involvement into the day-to-day regulation.\textsuperscript{137}

Compared with the Core Rules, the Third Tier rules were extensively detailed.\textsuperscript{138} These were supposed to derive from the Core Rules. They were written by the SROs exclusively and with the view of covering matters relevant to their particular area of expertise. The designation of the Core Rules obviously limited the scope for practitioner input, but the SROs differed in the extent to which they felt bound by it.\textsuperscript{139} The third tier rules performed five main functions: “detailing, clarifying, expanding, gap-filling”, and defining the application of the rule.\textsuperscript{140} Finally, the SROs made extensive use of Guidance, as it was hoped that this technique would make the

\textsuperscript{134} A. Large, \textit{Financial Services Regulation: Making the Two Tier System Work} (May, 1993), para. 4.15(iv).

\textsuperscript{135} The glossary was used for a multitude of purposes as, for example, to define certain terms, to correct mistakes made in the drafting of the Core Rules and, provide exceptions or safe harbours. J. Black above note 31, 120-121.

\textsuperscript{136} Derogations were part of the amendments that were introduced by the Companies Act 1989, where the provision was made for the designated rules to specify the extent to which the rules would apply to a firm, subject to the rules of its SRO, and for the rules to prohibit any modification or waiver in respect of any member. See specifically FSA 1986, section 47B and 63B, which were inserted by the Companies Act 1989, section 194. J. Black above note 31, 75 and 113-116.

\textsuperscript{137} In this manner the need to subject the Core Rules to frequent amendments was avoided.

\textsuperscript{138} For a detailed examination of the Three Tier Rulebooks see J. Black above note 31, 112-119.

\textsuperscript{139} J. Black above note 31, 123.

\textsuperscript{140} Above, 124.
conduct of business regime more flexible and adaptable to the rapidly changing market environment. Guidance explicated the application of a rule, indicated methods of compliance and stipulated conditions or standards that had to be met. The SROs also published periodic bulletins, whose main objective was to draw members’ attention to market and policy developments, to make them aware of newly discovered problems and to update them with respect to the SROs views about matters that have been referred to it.

3.7. Factors that influenced the three-tier system of rules

Several factors shaped the policy choice to introduce a three-tier system of rules. The problems that emerged as soon as the initial conduct of business Rulebooks were put into operation, the tension in the relationship between SIB and SROs and a number of changes in the institutional organisation of financial regulation -all left their own mark in these developments.

The latter was perhaps the only factor that had a beneficial impact on the policy of rule-use. As soon as powers were transferred to SIB, DTI had no further statutory control over the formation of SIB rules. As a consequence any political pressure for detail became weaker and weaker, and SIB enjoyed greater scope in performing its role as the principal regulatory authority. The pressure for speed was also moved away. Drafting rules to catch up with the rapid developments in the marketplace was no longer at the top of the regulators’ agenda. Once the initial rulebooks were

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141 J. Black above, 124-125.
142 Formal guidance should be distinguished from informal guidance, for example, interpretation of a particular provision given to a firm over the telephone. The former was binding, while the latter was not. Above, 125.
143 Above note 123, 92-93.
put into practice, their main concern was to remedy their deficiencies by making any necessary amendments.

Specifically, it didn’t take long for the regulators to realise the flaws of their approach to rule-use. Clearly, the balance was tipped too much in favour of certainty and predictability and at the expense of flexibility and adaptability. Practitioners were effectively excluded from the regulatory process, legalism prevailed and the regulated industry tended to comply with the letter rather than the spirit of the regulatory provisions. It should be noted, however, that the regime was faithful to considerations of legal certainty only in theory. In practice, it was becoming evident that any attempt to produce self-contained regulatory requirements was a chimera, and that the attainment of legal certainty and predictability entailed going beyond perfecting rule-design; more than anything, it required seeking ways to actively engage the regulated population with the day-to-day regulation and helping them become conscious of the burdens and responsibilities that this involved.

For once again, the increasing friction in the relationship between SIB and SROs made things worse. Practitioners had plenty of reasons to complain about. SIB’s approach to rule making manifested a profound and unwelcome departure from the originally envisaged model of self-regulation within a statutory framework. Indeed, SIB had a more dominant role than the one it was anticipated. Under these circumstances it was simply not possible to reap the benefits of self-regulation. It was urgent therefore to settle down the augmented discontent.

144 These are discussed at some length above.
145 In relation to the initial involvement of SROs in the production of rules it has been pointed out that “before… SROs had not been in a position to participate in the forming of the initial rules.” J. Black above note 31, 94. D. Walker ‘Some Issues in Regulation of Financial Markets’, Lecture at the Irish Centre for Commercial Studies, University College, Dublin (1991).
146 Things were intense between SIB and SROs. J. Black above note 31, 92-93.
The New Settlement addressed these problems. To start with, it redefined the relationship between SIB and SROs. The promulgation of statements of principle sent a firm message that SROs were going to play a more active role in rule-making, whereas SIB would concentrate its efforts and resources in providing leadership, standard setting and overall supervising and enforcing regulation. From then onwards, senior management would enjoy greater freedom –and heavier responsibility– to choose the techniques that would secure compliance with the rules. To reinforce the position of practitioners in the regulatory process, one more critical step was made. The rigid and in many respects unworkable “equivalence test” was replaced with the more lenient “adequacy test” as a measure for assessing SROs capacity to provide the appropriate level of investor protection in conformity with the statutory requirements. Furthermore, through the New Settlement, the attempt was made to reconcile two sets of clashing but equally desirable policy objectives: on the one hand, the need for certainty and predictability and, on the other hand, the need for flexibility and adaptability. The drafting of regulatory requirements in the form of guidance and the creation of the Core Rules served exactly that purpose. Finally, the incorporation of several innovative features into the design of rules, notably the glossary and the availability of derogations intended to make the rules brief, simple and adaptable.

3.8. Further problems and the publication of the Large Report

The analysis so far suggests that a number of initiatives were taken to simplify the design of rules, to reduce legalism and make the conduct of business regime more flexible and adaptable. It also reveals that special care
was taken to restore the troubled relationship between SIB and SROs. Despite these positive steps the situation was far from satisfactory.

The regulatory regime received various criticisms.\textsuperscript{147} It was widely felt that the objectives of the Act were not well defined, while the structure of the financial services regulation as well as the rulebooks had developed without a sense of overall purpose. The general impression was that regulators were too much absorbed drafting rules rather than setting broader objectives. Moreover, creative compliance continued to be an issue.\textsuperscript{148} The dissatisfaction with the policy of rule-use, which was introduced by the Companies Act 1989, did not stop there. It also derived from the fact that, despite the good intentions, the New Settlement failed in practice to rationalise the structure of the rules and tackle complexity. In this regard, the utilisation of the glossary and derogations is of particular interest.

It was said earlier that the glossary was a device that helped the drafters of the Core Rules to keep them brief, simple and durable. It was questionable, however, whether the glossary really made the rules more comprehensible and easy to read. Complexity did not vanish but removed from the rules to the appendix, whilst the lack of continuity in the text of the Core Rules made their reading confusing. An additional problem was that the glossary made the reading of the second-tier rules misleading because quite often it contained definitions that were different from market usage.\textsuperscript{149}

\textsuperscript{147} Above note 134, para.1.3; and J. Black note 31, 129-132.

\textsuperscript{148} The term “creative compliance” describes a situation where the interpretation fails to reflect the underlying purpose of the rule in question as a result of a strictly literal reading of the legal text. D. McBarnet and C. Whelan, ‘The Elusive Spirit of Law: Formalism and the Struggle for Legal Control,’ 54 Modern Law Review (1991), 848-873.

\textsuperscript{149} J. Black above note 31, 122.
The use of derogations was also problematic.\textsuperscript{150} For one thing, there were serious concerns that the sub-delegation of rule-making powers by virtue of derogations was ultra vires and therefore unlawful. It was also pointed out that derogations gave rise to legal uncertainty, as “they were not so much rules as an indication of something to follow”.\textsuperscript{151} Furthermore, their availability was at odds with the principal aim of drafting the Core Rules namely, the harmonisation of regulation through the provision of a backbone of Core Rules.\textsuperscript{152} For example, it was feared that the frequent use of derogations would undermine the statutory requirement of adequate investor protection to the extent it would allow inconsistencies between an SRO rulebook and other SRO rules.

Moreover, the role of SIB did not fit the overall character of financial regulation. SIB continued to act as the main rule-making agency. Accordingly it was felt that more progress had to be made in order to place SIB in a position, where it could actually act as the leading authority in financial regulation and as a guardian of the public interest.

Finally, the relationship between SIB and the SROs continued to be a thorny issue.\textsuperscript{153} For instance, the jurisdictional boundaries between the regulatory agencies were still under-defined and in several occasions contradictory. Undoubtedly, SIB had the complicated task to regulate the market and at the same time to be the regulator of the other regulatory bodies. In practice, the concentration of these conflicting duties required SIB officials to do the impossible namely, take decisions and act as if they had two different minds. Indeed, SIB had to treat SROs like partners in

\textsuperscript{150} The availability of derogations undermined the initiative to create a “common core of rules.” The variety of definitions of market-counterpart and indirect customers testifies this. Above, 116-119.

\textsuperscript{151} Above, 115.

\textsuperscript{152} J. Black above note 31, 113.

\textsuperscript{153} Above note 134, paras. 1.31, 1.37-1.39.
order to regulate the markets, but keep distance and objectivity where it had to supervise and monitor the performance of SROs or handle complaints against them.

In July 1992, the Large Report reviewed and partly addressed these criticisms. Based on the assumption that the above-mentioned problems were highly correlated, the Report focused on what it was thought to be the source of all evils that is, the problematic relationship between SIB and SROs. In this regard the Large Report recommended that SIB needed to act more as a guardian of the public interest in the regulatory system. It had to become more committed to the objective of investor protection and to be willing and able to exercise leadership. This entailed that SIB had to devote more efforts in setting objectives and standards of performance, ensuring that these were properly understood, and enforcing and supervising their performance rather than creating rules per se. Furthermore, the Report stressed the importance of greater transparency in the regulatory process as well as the need to pay attention to the costs of regulation.

SIB welcomed these recommendations and responded by taking a number of measures. These included the publication of a clear statement of the regulatory objectives in November 1993, the development of standards of regulation and the launch of standards of investor protection, which were accompanied by performance measures. The immediate result of these initiatives was a significant improvement of SIB’s capacity to monitor the performance of the various SROs and communicate effectively what it was

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154 I. MacNeil, above note 2, 732.
155 Above note 134, para. 1.64.
156 Above, para. 1.3.
157 Performance measures were intended to offer an objective basis for assessing compliance with what would still be subjective standards such as ‘integrity’ and ‘suitability’. Above note 134, para. 3.15-3.18. J. Black above note 31, 130-131.
expected by the regulated firms and what was the level of protection that investors were entitled to.\textsuperscript{158}

The Large Report had a remarkable impact on the evolution of the regulatory policy of rule-use. For one thing, it reformed the role of SIB. SIB was no longer the chief rule-maker. Instead, it became the leader regulator within the institutional structure of financial regulation, whose prime concern was the setting of standards as well as the supervision and the effective enforcement of regulation. As a matter of fact, “SIB would only be involved in rule-making and policy-making” in relation to the workings of a SRO, where the SRO in question “lacked the resources necessary to form policy, where an issue crossed regulatory boundaries,”\textsuperscript{159} or where the importance of a subject for the system as a whole” warranted “SIB taking the lead, in the interests of securing adequate standards and promoting consistency among front line regulators.”\textsuperscript{160}

Given that SIB were expected to provide leadership, the drafting of legally binding and highly specific rules, which would allow it to intrude into the workings of SROs and keep a close eye on how they exercised their discretion, was no longer considered to be necessary. The more intensive use of statements of principle and the introduction of management-oriented techniques (for example, the publication of statements of aims and objectives, the identification of action points, the reorganisation of internal management of SIB, the production of management and budget plans, and the design and implementation of quantifiable performance targets) were thought to be more appropriate in assisting SIB to its new role.\textsuperscript{161}

\textsuperscript{158} Above, para. 3.12.
\textsuperscript{159} Above, paras. 6.9-6.10. J. Black, above note 31, 132.
\textsuperscript{161} Above; and J. Black, above note 31, 131.
The renewed emphasis on statements of principle manifested a more general change of attitude towards rule following. It indicated that the architects of the regime were now confident that public support and political approval could be gained through persuasion rather than by way of harsh measures and tight controls. Of course, it was not the first time that officials expressed their commitment not to exclude practitioners from the workings of the day-to-day regulation. However, it was the first time after the launch of the Financial Services Act in 1986 that conditions were mature for this to happen. Indeed, the policy choice to draft rules in the form of statements of principle created the necessary space for SROs to facilitate the channelling of practitioners’ input into the regulatory process, to promote the flourishing of communities of interpreters and to make possible the adoption of a communicative style of regulation.

Although the Large Report was well received, several policy choices raised concerns and scepticism. For example, in relation to self-regulation, it was pointed out that when it comes to policy-making, rule-making and enforcement some kinds of self-interest might be difficult to detect and control.\(^\text{162}\) Similarly, the expediency of introducing a system of process related, quantitative standards as a benchmark device for clarifying the purposes of the FSA 1986 was criticised because it would encourage regulators to operate in a mechanical way.\(^\text{163}\) By the end of 90’s, growing dissatisfaction triggered a new wave of developments that were eventually crystallised in the policy of rule-use of our days.


\(^{163}\) Above, 2-3 and 12.
4. Conclusion

In this chapter I examined the evolution of the policy of rule-use in financial regulation that preceded the FSMA regime. I argued that the policy choice to construct conduct of business rules of a particular type as well as to deploy them in a certain fashion was shaped by the interaction of mainly two factors: the institutional structure of regulation and the special features of the regulated industry of the time.

Specifically, the policy of rule-use evolved into three subsequent stages. The first phase had as its starting point the introduction of the Financial Services Act 1986, which was the Government’s response to a chain of dramatic market changes in the City of London. Under the FSA 1986 financial regulation was grounded on hybrid institutional forms combining state and private elements. The result was a multi-tier regulatory structure and comprised three levels. At the top (‘governmental level’) were the Treasury, the Office of Fair Trading and the Department of Trade and Industry. At the central level was the Securities and Investments Board (SIB). At the third level (‘practitioners level’) were the self-regulatory organisations, regulated professional bodies, exchanges and clearing houses.

The institutional and market context of the time had a remarkable impact on the policy of rule-use. The eroded market homogeneity, the mounting uncertainty, which caused by the unprecedented changes in the market landscape combined with the distrust among DTI, SIB and SROs led initially to the production of extremely detailed and prescriptive conduct of business rules. Rules drafted in high level of detail served a wide range of purposes: to make the production of rules less time consuming, to control the exercise of interpretive discretion, to keep the increased litigation risk –
the outcome of a generous provision of a civil right of action in section 62 of the Act- at minimum etc. Yet, the FSA 1986 policy of rule-use was not an ordinary “command and control” regime. Self-regulatory elements were incorporated into the institutional structure to keep the regulated population happy and secure its co-operation.

The initial policy of rule-use failed not least because it suffocated any attempt to take advantage of the self-regulatory elements that were preserved under the FSA 1986. Clearly the balance was tipped too much in favour of certainty and predictability and at the expense of flexibility and adaptability. The New Settlement launched a number of measures to address these shortcomings. It restricted the private right of action under section 62 of the FSA. It substituted the statutory requirement of ‘equivalent’ level of consumer protection with the more lax requirement of ‘adequate’ investor protection. In terms of rule design, it emphasised the crucial role of Principles and introduced a three-tier system of rules. A number of factors put pressure towards the adoption of a less prescriptive regulation. The need to address the flaws of the initial rulebooks was one of them. An additional source of change was the fact that SROs was allowed for the first time to have some contribution to the production of rules and that DTI could no longer influence rule making.

The New Settlement was not free from problems. It was felt that the objectives of the Act were flawed and that the rulebooks were developed without a sense of overall purpose. Furthermore, the relationship between SIB and the various SROs remained in many respects unsettled. The Large Report in 1992 dealt with these problems in the following way. It cemented SIB’s leadership role in financial regulation and stressed the desirability of adopting a more purposive and compliance oriented approach to regulation.
These ideas figured in policy debate before. However, with the Large Report the attempt was made to spell out their institutional implications in a more sophisticated manner. The progressive reliance on Principles, the resort to cost-benefit analysis, the emphasis on regulatory transparency and the putting into place of concrete performance measures all testify this development.
CHAPTER THREE

The Evolving Regulatory Policy of Rule-Use -the FSMA 2000 Regime

1. Introduction

This chapter continues to explore the regulatory policy of rule use -this time, as it evolved as soon as the Labour Government announced substantial institutional reform in financial regulation and up until the end of 2006. The chapter falls into four parts. The first part considers the policy developments that led to the promulgation of the Financial Services Act 2000 and the launch of a single megaregulator –the Financial services Authority (FSA)- as well as the present institutional structure of financial regulation. The second part examines the background of the FSA policy of rule-use. Its characteristics are discussed in the third part. In this connection, emphasis is placed on the sophisticated design and structural interrelation of the regulatory norms and on the purposive, communicative and risk based nature of their application and enforcement. Finally, the fourth part of this chapter engages with some difficulties that are endemic in the FSA’s policy of rule use. In this context special reference is made on the impact of the implementation of the Markets in Financial Instruments Directive (MiFID) on the FSA policy of rule-use.
2. Further institutional reform: the move towards as single regulator

After the Large Report, things didn’t rest for long. Mounting dissatisfaction triggered a new wave of developments. On May 1997 the Chancellor of the new Labour government announced in Parliament that the Bank of England would be given operational independence in matters of monetary policy.\(^1\) Later on he confirmed that the supervisory and regulatory functions of the Bank of England under the Banking Act 1987 would be transferred to SIB and SIB would replace SROs and thus become directly responsible for the supervision of the securities industry on statutory basis. The Chancellor justified this decision by bringing attention to the inefficiencies of the existing system of regulation and its failure to deliver a high level of consumer protection. He further pointed out that the proliferation of hybrid financial products and services –a clear manifestation of the increasing blurring among the banking, securities and insurance industry- meant that it no longer made sense to subdivide the responsibility for financial regulation on functional basis.\(^2\)

A number of transitional steps followed.\(^3\) On July 1997 a report was prepared by SIB (in cooperation with eight other sectoral self-regulatory and statutory bodies) and submitted to the Chancellor. The report set out the core proposals for the creation of economies of scale and scope both in institutional and normative level, it included an outline of the necessary arrangements for their implementation, as well as a timetable. On August 1997 the Deputy Governor of the Bank of England -Howard Davies- was

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\(^3\) During the transitional period sectoral regulators formally retained their responsibility for their respective areas but the supervisory responsibilities were carried out by FSA.
appointed Chairman of SIB and was entrusted with the task to lead the transition and head the new megaregulator. Existing staff that was previously employed by the SROs was re-employed by the FSA on a subcontract basis. On 28 October 1997, the Financial Services Authority was launched and the publication of a *Memorandum of Understanding* set out the relationship between FSA, the Treasury and the Bank of England. The banking supervisory functions of the Bank of England were transferred to FSA under the Bank of England Act 1998. Around the same time the sectoral regulatory statutes were replaced by a single, unitary statutory framework the Financial Services and Market Act 2000 (FSMA). The FSMA is the normative counterpart to the organisational integration of the regulatory authorities. It contains provisions concerning the establishment of the new authorisation and permission regimes, the issuance of rules and guidance, enforcement, accountability and transparency and rules making provision for a new integrated Ombudsman and Compensation arrangements. The FSMA regime differs from its predecessor in various respects. Self-regulation was abandoned for a statutory based regime. The scope of regulation was expanded and so it did the scope of the functions

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5 This is referred to as ‘N1’. Before that FSA had the statutory responsibilities of SIB.

6 FSA has regulatory powers under a number of other non-FSMA legislation: (a) the Building Societies Act 1986; (b) the Friendly Societies Act 1974 (and 1992); (c) the Industrial and Provident Societies Act 1965; (d) the Enterprise Act 2002 (it is designated as consumer enforcer where collective consumer interests are at stake); (e) Unfair Terms in Consumer Contract Regulations 1999 (may seek an injunction to prevent the use of the contract term drawn up for general use in a financial services contract that appears to the FSA to be unfair); (f) Distance Marketing Regulations 2004 (it may take action against persons responsible for breaching specified contracts); (g) Electronic Money Directive (it is responsible for the regulating the issuing of e-money).

7 Before the FSMA 2000 was enacted FSA was operating as a de facto single regulator. A. C. Fawcett, ‘Examining the Objectives of Financial Regulation. Will the New Regime Succeed? A Practitioner’s View’ in E. Ferran and C. A. E. Goodhart (ed.) *Regulating Financial Services and Markets in the 21 Century*, ch.4 at 37.

vested to the new megaregulator. Yet, the real novelty of the FSMA 2000 has been the inclusion of four regulatory objectives and the assignment to FSA of important policing functions especially with regard to money laundering and market abuse. On June 14, 2000 the FSMA received Royal Assent, almost after two years of its original publication in draft form. On December 1, 2001 the FSMA 2000 entered into full force and FSA acquired full and direct responsibility for the regulation and supervision of the UK financial intermediaries (banks, building societies, insurance companies, friendly societies, credit unions, Lloyd’s, securities firms, derivatives traders, investment and pensions advisers and managers, collective investment schemes). The transitional period was fully complete by early 2004 when the regulatory responsibility in respect of mortgage sales and general insurance was transferred to FSA.

3. The current institutional structure

FSA is a quasi-independent administrative agency. It is a company limited by guarantee vested with direct statutory functions by virtue of which it is the policy-maker, rule-maker and enforcer of financial regulation. FSA is responsible to promote a multitude of statutory objectives namely, market confidence, public awareness, consumer protection and the reduction of financial crime according to principles of good administration as stated in

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10 On the legislative process and the topics of debate see H. Davies, above note 8, 17-9 and 19-21.
11 This date is referred to as ‘N2’. From that time the new system was in effect in law as well as in practice. W. Blair, A. Allison, G. Martin, K. Palmer, P. Richards-Carpenter and G. A. Walker, Banking and Financial Services Regulation (2002), paras. 2.1-2.3.
12 This date is known as ‘N3’. See above, paras.2.2-2.3.
the FSMA 2000. Its public powers include: (a) the authorisation and supervision of financial intermediaries; (b) the investigation of suspected misconduct; (c) the imposition of administrative sanctions and the prosecution of criminal offences; (d) the monitoring the conduct of the so-called ‘approved persons’ (that is individuals carrying in key functions within authorised financial institutions) and; (e) the official listing of publicly traded securities in the UK.

FSA performs its operation along the lines of a single managerial structure. The rationale for this choice was the achievement of economies of scale and scope. It consists of (a) the Board; (b) the Chief Executive; (c) three managing directors, each leading a business unit – retail markets, wholesale and institutional markets and regulatory services; (d) a number of functions which report direct to the Chief Executive and; (e) eight ‘sector leaders’ that is, staff directors with cross-FSA responsibilities for defined sectors or issues. There are also sectoral teams, which develop expertise and ensure that issues relevant to their sector are identified and resolved as quickly as possible.

The accountability of FSA is secured by way of corporate governance requirements and provisions relating to the exercise of public control. The FSMA 2000 requires the participation in the Board of a majority of non-

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15 The principles of good regulation are: (a) efficiency and economy; (b) responsibility of business managers; (c) proportionality; (d) facilitating innovation; (e) maintaining the UK’s competitive position internationally; (f) no unnecessary distortion of competition; and (g) the facilitation of competition.

16 FSMA 2000, s.31.

17 FSMA 2000, Part XI.


19 FSMA 2000, s.168.

20 FSMA 2000, s.33.

21 FSMA, Part VI (ss. 72-103) and Sch.7-11.

22 Above note 9.

23 FSMA 2000, Sch.1.


executive members and the establishment of a committee of non-executive members with financial scrutiny role. In addition, FSA has the obligation to submit the annual report to the Treasury and the Houses of Parliament and publish it. The Treasury retains the power to appoint and remove the agency’s Chairman and the Board. It is also authorised to initiate independent inquiries for the investigation of serious regulatory failures in the public interest, as well as independent audits. Apart from that, the Treasury is entitled to order FSA to change rules and practices in various occasions as, for example, when regulatory provisions are deemed to be anti-competitive by the Director General of Fair Trading or where FSA fails to comply with UK international obligations.

To ensure compatibility with the Human Rights Act 1998, FSA is expected to comply with a range of other procedural and consultation requirements when taking disciplinary action. Furthermore, the regulatory Authority is under the obligation to maintain internal procedures guaranteeing that enforcement action is fair and consistent. A major development in this regard has been the separation of functions between FSA staff investigating a case and FSA staff taking the decision to proceed with enforcement action.

Under the FSMA, a broad range of financial and quasi-financial activities fall within the regulatory pitch: dealing and arranging deals in ‘investments’,

26 FSMA 2000, s.7 and Sch.1.
27 FSMA 2000, Sch.1 para.10.
28 FSMA 2000, Sch.1 para.2(3).
31 FSMA 2000, ss. 163 and 405.
deposit taking, safe-keeping and administration of assets, investment management, investment advice, the establishment of collective investment schemes, the use of computer-based systems for giving investment instructions.\(^{33}\) The regulatory regime is built around a statutory prohibition on carrying on any regulated activity or promoting investments without authorisation.\(^{34}\) FSA has the power to grant, modify and withdraw such authorisation as well as to continuously supervise authorised institutions. Authorisation does not involve an automatic right to provide financial services of all descriptions. It simply means that the institution has been given permission to conduct a specified range of financial activities, which FSA deems appropriate in the view of the institution’s individual circumstances.\(^{35}\) The FSMA contains threshold conditions for the granting of permission to an institution.\(^{36}\) It should be noted, however, that FSA’s decision is discretionary.

Authorised institutions as well as the individuals who carry out certain key managerial and control functions on their behalf are subject to supervision and must adhere to prudential and conduct of business requirements.\(^{37}\) Changes in the ownership of regulated institutions are subject to regulatory vetting.\(^{38}\) FSA has extensive powers to request information on ad hoc basis and to launch investigations on suspected contraventions of regulatory requirements.\(^{39}\) Similarly, the enforcement powers of the Authority are much more comprehensive than those under the predecessor regime. FSA has a variety of enforcement tools in its disposal.\(^{40}\) It can take disciplinary

\(^{33}\) FSMA 2000, s.22 and Sch.2.
\(^{34}\) FSMA 2000, ss. 19 and 21.
\(^{35}\) FSMA 2000, s. 31(1) and Part IV (ss.40-55).
\(^{36}\) FSMA 2000, s.41 and Sch. 6.
\(^{38}\) FSMA 2000, Part XII (ss.178-192).
\(^{39}\) FSMA 2000, Part XI (ss. 165-177).
measures in the form of public censure or administrative fines.\textsuperscript{41} It can initiate court proceedings for injunctions or restitution orders.\textsuperscript{42} FSA may also initiate insolvency proceedings against regulated institutions\textsuperscript{43} and prosecute offences under the FSMA and subordinate legislation.\textsuperscript{44} To avoid arbitrariness, FSA has established a clear separation of roles between those who investigate a case and those who decide on potential enforcement action.\textsuperscript{45} In the same spirit, enforcement action follows a standard pattern which involves the service of formal warning and final decision notices explicating the reasons for action, the disclosure of relevant evidence, allowance of a period for representations to the institution concerned as well as to certain third parties.\textsuperscript{46}

FSA also has extensive policy and rule making powers. Numerous statutory provisions enable FSA to adopt norms on a wide range of substantive matters.\textsuperscript{47} Granted that the FSMA 2000 contains a set of four general policy objectives, which are coupled with relatively fewer concrete policy prescriptions, the regulatory Authority enjoys considerable scope of legislative autonomy both with regard to the substantive content of the regulatory norms and the means and intensity of their application. Nonetheless, the FSMA sets up certain procedural safeguards in relation to

\textsuperscript{41} FSMA 2000, Part XIV (ss.205-211). According to FSMA 2000 section 66, this is exercisable over approved persons in the event of their “misconduct”. R. v FSA, ex parte Davies [2003] 1 WLR 1284; and FSA Final Notice for St James Place UK plc, St James Unit Trust Group Ltd, St Jame’s Place International Plc (24 November 2003); FSA Final Notice for Abbey National Asset Managers Ltd (9 December 2003); FSA Final Notice City Index Ltd (22 March 2005).

\textsuperscript{42} FSMA 2000, Part XXV (ss.380-386). See, for example, FSA v Martin, [2006] PNLR 11 (restitution order); FSA v Fitz, [2004] EWHC 1669 (freezing injunction).


\textsuperscript{44} FSMA 2000, Part XXVII (ss.397-403).


\textsuperscript{46} FSMA 2000, Part XXVI (ss.387-396). Despite these procedural requirements, the fairness of the scheme has been disputed in a number of decisions by the Financial Services and Markets Tribunal. Geoffrey Alan Hoodless and Sean Michael Blackwell v FSA (3 October, 2003); and Sir Philip Watts v Financial Services Authority (7 September 2005).

\textsuperscript{47} FSMA 2000, Part X (ss.138-164).
regulatory rulemaking. FSA has the obligation to establish a consumer and a practitioner panel, and consult with them when making policy or rules.48 Rulemaking is further subject to public consultation.49 Moreover, where the rule is likely to involve huge regulatory costs, its publication must be coupled with cost benefit analysis.50

In exercising its policy and rule making functions, FSA must pursue a set of express statutory objectives. These are the maintaining of confidence in the financial system, promotion of public awareness, consumer protection and the reduction of financial crime.51 In doing so, FSA must take into account a number of mandatory considerations, known as “principles of good regulation;”52 the need to use its resources in the most efficient and economic way, the responsibilities of the management of authorised firms, the principle that the regulatory burdens and restrictions imposed on private persons are proportional to the benefits which accrue from them, the desirability of facilitating innovation, the international character of financial services and markets, the need to protect the UK’s competitive position and the principle that regulation should not restrict or distort unnecessarily competition between market participants.53 FSA is also committed to a system of risk-based regulation.54

Although FSA is now the UK’s single financial regulator, the Bank of England and the Treasury have key roles in the regime.55 The Memorandum

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48 FSMA 2000, ss.8-11.
49 FSMA 2000, s.155.
51 FSMA 2000, ss.2-6. The provision of a set of statutory objectives alongside principles of good regulation served as a benchmark for evaluating FSA’s performance and cementing its public accountability. E. Lomnicka, above note 8, 65.
52 FSMA 2000, ss.2 and 7. Above note 14, 10-11.
53 FSMA 2000, s.2(3).
54 H. Davies, above note 8, 23-24; and note 14.
of Understanding between the regulatory bodies provides a framework of cooperation for the attainment of the common policy of objective of financial stability. It contains a clear description of the roles of each of the bodies involved in the regulation of financial markets and, further, amplifies the four fundamental principles, which form the basis of the division of regulatory power under the FSMA 2000. These are (a) clear accountability of the regulatory bodies; (b) transparency of functions; (c) no overlap of functions and (d) exchange of information to ensure efficient discharge of functions. According to the Memorandum of Understanding each body is required to inform the others and consult with them if a policy change appears to have an impact on the responsibilities of the other bodies. Furthermore, the Bank of England is represented on the FSA Board and likewise, the Chairman of FSA has a seat on the Board of the Bank of England.

4. Policy background

Most of the ideas that lie beneath the FSA policy of rule-use were already in place before the introduction of the FSMA 2000. The emphasis on outcomes, the progressive decentralisation of decision-making and reliance on the discretion of the regulated firms, the idea that regulatory responses must be reflexive and proportionate to the particular circumstances of each individual case, the desirability of strengthening the cooperation between the regulator and the regulated population with the view of cultivating a common understanding of the regulatory norms figured already in the latest phase of the policy of rule-use under the FSA 1986 regime. The effective operationalisation of these ideas, however, was less than satisfactory.
The major institutional reform in the field of financial regulation at the end of 90’s gave an excellent occasion to review these ideas and to work out new ways to bring them into practice.\textsuperscript{56} The publication of the FSA Consultation Paper on the Design of the FSA Handbook of Rules and Guidance in April 1998 instigated a painstaking preparatory work on the architecture of the normative aspect of financial regulation.\textsuperscript{57} At this preliminary stage, the aim was to clarify the design-objectives and design-principles of the FSA Handbook. FSA identified three sets of objectives: (a) communication, namely the capacity of regulatory provisions to communicate to the regulated population what is required for them in organisational and behavioural terms; (b) consistency, which was understood as making sure that regulatory provisions are internally coherent and differentiate only where it is appropriate and; and (c) implementation, which required striking a balance between effective enforcement and maintaining a level of latitude for regulated firms to decide how to comply with regulatory requirements.\textsuperscript{58}

The elaboration of the design principles that would underlie the architecture of the Handbook proved to be a more challenging project, given that the design-principles had to be carefully crafted so that they would be effective in dealing with problems as diverse as making rules durable and at the same time adaptable, promoting effective enforcement but also preserving some space for firms to decide themselves how to comply with regulation, promoting certainty and being at the same time flexible when differentiation was prescribed on policy considerations. In an attempt to accommodate all these competing objectives, FSA came up with five design principles:\textsuperscript{59} (a) a

\textsuperscript{56} These changes constitute part of the so-called ‘Better Regulation Movement,’ a broader initiative of the Labour Government to improve the performance of public administration, whose roots can be traced back to the deregulation policies of the Conservative Government in the 80’s. R. Baldwin ‘Is Better Regulation Smarter Regulation?’, \textit{Public Law} (2005), 485 at 485-487.

\textsuperscript{57} FSA, ‘Designing the FSA Handbook of Rules and Guidance’, \textit{FSA Consultation Paper No.8} (April, 1998).

\textsuperscript{58} See above, 10-12.

\textsuperscript{59} Above note 57, 15-16.
succinct authoritative statement of high-level principles, (b) a backbone of further rules to cater for the enforceability and other needs; (c) guidance; (d) presumption against differentiation;\(^6\) (e) regulatory standards should focus on firms’ outputs and the adequacy of internal systems and controls.

In August 1998, nearly six months after the publication of the design-objectives and design-principles, the development of the FSA’s policy of rule-use entered into an interim phase of evolution. This was marked by the publication of an additional paper where FSA discussed the industry’s reactions to its proposals, clarified certain aspects of the practical implications of its proposed policy and, set out further proposals dealing with the final design of regulatory provisions and the approach that were to be followed in setting and implementing regulatory standards.\(^6\) FSA declared that the regulatory requirements would be implemented according to their purpose and underlying values\(^6\) and always in light of the peculiarities of each situation. To this end, the regulatory Authority would communicate and cooperate with the regulated firms and –where appropriate- avail itself with the use of modifications, waivers and other more informal methods for ensuring compliance with regulatory requirements.\(^6\) In addition, it would rely on the extensive use of codes and guidance to promote certainty and predictability.

The development of the FSA’s policy of rule use accomplished its latest phase with the integration of financial regulation into a single normative framework -the Financial Services and Market Act 2000.\(^6\) Several chapters


\(^6\) FSA, *Financial Services Authority: Meeting our responsibilities*, (August 1998).

\(^6\) Above, para. 96.

\(^6\) Above paras. 87 and 88.

\(^6\) C. Hadjiemmanuil, above note 40, 127-190; and note 8, H. Davies, 20.
and sections of the Act are devoted in laying down a comprehensive framework for the FSA’s policy of rule-use along the lines of the earlier policy proposals. Of particular importance are those chapters and provisions setting out principles of good regulation and governing the exercise of rule-making powers, provisions establishing accountability benchmarks and provisions prescribing the procedural aspects of disciplinary and enforcement action. Based on these statutory prescriptions, FSA published a sophisticated net of secondary legislation, the FSA Handbook of Rules and Guidance (the Handbook). The Handbook is an exemplary case of legal draftmanship and comprises currently six modules on high-level standards, nine modules on business standards, four modules on regulatory processes and a number of specialist rulebooks and guides applicable to more idiosyncratic categories of regulated firms. Ever since its publication the FSA Handbook has been the subject of a laborious revision whose purpose has been to ensure that the design of the Handbook keeps up with market developments and reflects more accurately the regulator’s policy of rule-use. The nature of this policy is considered next.

65 Part X of the FSMA 2000 confers upon FSA rule making powers for authorised persons and, in addition, gives FSA the power to issue guidance on regulatory matters.
66 Examples include FSMA provisions from Part I such as section 2 (the Authority’s general duties), sections 3 to 6 (the regulatory objectives, section 7 (corporate governance) and, sections 8 to 11 (arrangements for consulting practitioners and consumers).
67 See, for example, Part XXVI of FSMA 2000 on the issuance of notices especially section 387 (warning notices), section 388 (decision notices), section 395 (the Authorities procedures) and section 396 (statements under section 395: consultation).
69 Including general principles for business; rules on senior management; systems and controls; threshold conditions for authorisation; a set of principles and a code of conduct for person exercising certain regulated functions within authorised institutions ('approved persons' FSMA, Part V); a fitness test for ‘approved persons’; and general provisions.
70 Including separate prudential sourcebooks for banks, building societies, insurers, friendly societies and investment business; and modules of conduct of business, market conduct, training and competence of staff, and money laundering.
71 That is authorisation, supervision, enforcement and decision-making.
5. Decoding the nature of the FSA’s policy of rule-use

5.1. Introduction

Having summarised the development of the FSA’s policy of rule-use, I will now attempt to overview the key elements of this policy. As it will be shown, the Authority’s policy of rule-use is a unique amalgam, on the one hand, of outstandingly sophisticated architectural features of the Handbook and, on the other hand, of a purposive (commonly known as “principles-based”), communicative and risk-based practice of rule formation, application and enforcement. While the sophisticated design of the regulatory norms and their legal framework was considered to be the crucial step to make rules more accessible and easy to understand, purposiveness was expected to foster compliance with the spirit rather than the letter of the regulatory norms, encourage the development of market-based solutions and overall reduce the cost of rule-use. Furthermore, the incorporation of communicative elements and the adoption of a risk-based approach were intended to cement the participatory and reflexive nature of the Authority’s policy of rule-use in an economically efficient manner.

5.2. The design of FSA Handbook

The FSA Handbook of Rules and Guidance is a piece of secondary legislation that sets out the bulk of the FSA’s regulatory provisions and epitomizes its policy of rule-use. Overall, the Handbook is an extraordinary case of legal draftmanship. A mixture of different types of rules\(^{72}\) has being

\(^{72}\) According to the FSMA 2000, FSA is endowed with powers to promulgate secondary legislation in a variety of forms such as principles, rules, guidance and codes of practice, directions and requirements. FSMA 2000, Part X chapter I (rule-making powers) and chapter II (guidance) and Part V, section 64 (conduct and statements and codes). Significantly, not all of them are legally binding, whereas some of them may be limited in their scope of application. M. Blair et al. note 13 (2002), 138-141. On the design of
used in order to address the problems of over- and under- inclusiveness and that of legal indeterminacy. Their typology is extremely refined and their lay out follows a complex –though standardised- pattern. Alongside high-level principles, rules and guidance now figure regulatory provisions identified as “directions”, “requirements”, “standards” and “evidential provisions”. Those of the regulatory provisions that are stated in an abstract manner are linked with a range of other provisions framed in more concrete terms. Together, they comprise an organic whole, in the sense that the latter serve to explicate the content of the former, to give information about its legal status and enforceability, to advise on its proper interpretation and to offer examples or further guidance. Additional information on regulatory requirements is contained in separate schedules included in the modules. These deal with issues such as transitional provisions, record keeping, notification and reporting requirements, rules that can be waived or modified and rights of action for damages under section 150 of the FSMA 2000.

The provisions in the Handbook are found in hierarchical order. In line with a principles-based approach to regulation, high-level principles stand at the top of the hierarchical ranking. They are superior in that they are the ultimate regulatory norms in written form that define what will be regarded as acceptable or non-acceptable market behaviour. Detailed prescriptive rules and guidance are inferior in that they perform a supplementary

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74 FSA considers that there is such an intimate link between high-level principles and the detailed rules, so that in one of his recent speeches Callum McCarthy, the Chairman of the FSA, pointed out that it is misleading to characterise the FSA’s regulation as ‘principles-based’. Taking into account that there are currently 8,500 pages of rules, the FSA could “equally … be described as rule bound regulator.” C. McCarthy, ‘Financial Regulation: Myth and Reality’, FSA Speech, (13 February, 2007).
77 Above, J. Tiner, 1-4.
function. Rules are used only when it is absolutely necessary and serve to explicate the content and implications of high-level principles and - depending on their level of concreteness- stipulate enforcement action. Guidance performs a multitude of functions including the clarification of the form and manner of compliance, the development of market-based solutions to market failure and the overall maintenance of communication between FSA and the regulated population. All these regulatory provisions comprise currently the content of specialist sourcebooks, guidance, sector-specific Handbooks and glossaries.

An impressively wide range of accessories and other navigating tools are intended to make the Handbook user-friendly and accessible. The FSA Handbook is accompanied by Handbook Guides and Regulatory Guides as well as a special booklet –the Reader’s Guide-, which is designed to inform on the structure and contents of the Handbook and its related materials, their interpretation and further explain how different modules fit together. Letter icons ensure that the type and legal status of each provision is always made clear. For instance, the letter R stands for rules, the letter E for evidential provisions, the letter G for Guidance and the letter C to signal out paragraphs made under section 119(2)(6) of the FSMA 2000 specifying descriptions of behaviour that in FSA’s opinion do not amount to market abuse. Flag icons serve to distinguish those legislative materials that were not produced by FSA. Numbering, cross-referencing and italics are employed extensively to indicate terms defined in the Glossary while informative notes are added for the convenience of the readers. Finally, the

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78 Above, 2-5.
79 Tiner, above note 76, 4-5.
80 FSA has produced fourteen sector-specific Handbooks for small firms. Each one of them is about 90% smaller than the full FSA Handbook. Above, 16
81 Above note 75, 2.
82 These fall in either of the two categories: non-FSA UK or EU materials that are directly applicable. The UK flag icon is used for the former, while the EU flag icon designates the latter.
The various provisions of the Conduct of Business Sourcebook offer an excellent case study of the design of the FSA Handbook. The first thing to notice is that there is a division of labour among regulatory provisions. For example, COB 2.1, which provides that firms have the obligation to conduct clear, fair and not misleading communication, contains separate rules and guidance explaining the application (COB 2.1.1 (R)) and purpose (2.1.2 (G)) of this regulatory requirement and separate rules and guidance stating the regulatory requirement per se (COB 2.1.3 (R), COB 2.1.4 (G) and COB 2.1.5 (G)). In addition, COB 2.1.2 (G) establishes the structural inter-relation between COB 2.1 and Principle 7 of the FSA Handbook (‘Communication with Clients’) and explains the rationale for using a detailed and prescriptive rule alongside Principle 7, which is inter alia to enable a customer to bring a legal action for damages under section 150 of the Financial Services and Markets Act 2000. Moreover, the interaction between COB 2.1.3 (R) and COB 2.1.4 (G) and 2.1.5 (G) is of particular interest as it is a standard example where the content of a legally binding regulatory requirement (COB 2.1.3 (R)) is further explicated by way of non-legally binding guidance in the sense that regulatory provisions COB 2.1.4 (G) and COB 2.1.5 (G) help firms to understand whether their conduct is in conformity with the regulatory requirement to communicate in clear, fair and not misleading manner. Similarly COB 2.4 (Chinese Walls) consists of (a) subsections COB 2.4.1 (R), COB 2.4.1 A (R), COB 2.4.2 (G) and COB 2.4.3 (G), whose

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83 Personalised Handbooks present the content of the FSA Handbook in a manner that fits the peculiar features of the firm. Focus-on Handbooks deliver the content of the FSA Handbook presented by subject matter. Above note 76, FSA, 11.

84 This regime will be replaced by the NEWCOB (also referred to as ‘COBS’), which will take force on November 1, 2007. It is expected that COBS will be more detailed and prescriptive. See also the discussion on the implementation of the Markets in Financial Instruments Directive and its impact on the FSA’s policy of rule-use below.

85 For instance, COB 2.1.4 (G) states that ‘when considering COB 2.1.3 (R) a firm should have regard to the customer’s knowledge of the designated investment business to which information relates.’
sole objective is to explain the application and purpose of this regulatory requirement, (b) subsection COB 2.4.4 (R), which sets out what FSA requires from firms to do; and (c) a number of other subsections, which by way of guidance explain matters such as the legal effect of complying with COB 2.4.4 (R), and the attribution of knowledge in certain circumstances. For once again special care is taken to stress the hierarchical inter-relation between COB 2.4 and Principle 8 of the FSA Handbook governing conflicts of interest.

Finally, all COB provisions -including COB 2.1 (clear, fair and non misleading information) and 2.4 (Chinese Walls)- are ornamented with all the accessories and navigating tools that were mentioned above as for example letter icons indicating the legal status of the regulatory provisions. In addition, the electronic form of the text opens up a wide range of possibilities for the reader including immediate access to the glossary, other parts of the FSA Handbook or even to other legal instruments that it might be of his or her interest as well as the taking of notice of the New Conduct of Business Sourcebook that is going to have legal force from 1 November 2007.  

Given the notional and structural link between COB regulatory requirements and the eleven Principles for Business, the former cannot be read with out reference to the latter. In terms of their lay out, the Principles for Business bear similarities with COB regulatory requirements. Features that share in common include the division of labour among different regulatory provisions, the presence of a regulatory provision (PRIN 1.1.9 (G)) that emphasises the hierarchical inter-relation between the high-level principles and COB rules and guidance, which are found in

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87 The Principles for Business are part of the Second Block (‘High Level Standards’) of the FSA Handbook.
separate Block of the FSA Handbook, and the extensive availability of navigating tools and other accessories which aim at making their reading user-friendly.\textsuperscript{88} However, there are several structural characteristics that are peculiar to the high-level Principles for Business due to their different functional purpose. For example, PRIN 1.1.2 (G) explains the purposes of regulatory requirements that fall under the heading of Principles for Business and, in addition, stress the notional link between the Principles of Business and the regulatory objectives stated in the FSMA 2000. Likewise PRIN 1.1.8 makes clear how the Principles for Business become relevant to the exercise of various FSA powers (e.g. powers to gather information, conduct investigation and vary a firm’s permission or apply in court for an injunction or restitution) and explicitly states that Principles “do not give rise to actions for damages by a private person...” Last but not least, PRIN 1.1.9 makes special reference to the implication of the nature of the Principles for Business with respect to other FSA rules and guidance, stating that “since the Principles are also designed as a general statements of regulatory requirements applicable in new or unforeseen situation, and in situations in which there is no need for guidance, the FSA’s other rules and guidance should not be viewed as exhausting the implications of the Principles themselves”.\textsuperscript{89}

5.3. Purposive regulation

The purposive character of the FSA’s policy of rule-use manifests that the FSA’s approach to regulation is outcome-oriented. Its roots can be traced

\textsuperscript{88} Of particular interest is note 1, which provides access to the statutory instrument ‘MIFID (MISCELLANEOUS AMENDMENTS) Instrument 2007’ that introduces changes to various PRIN provisions so that they are in conformity of MiFID requirements. [http://fsahandbook.info/FSA/html/handbook/PRIN/1/1]

\textsuperscript{89} See, http://fsahandbook.info/FSA/html/PRIN/1/1. Recent case where FSA made use of its power to initiate enforcement action on the basis of general standards is the Standards of Regulatory Responsibility in Legal and General Assurance Society v FSA (Financial Services and Markets Tribunal, 18 January 2005).
back to the four regulatory objectives specified in the Act. It underpins the
genesis, application and enforcement of rules and becomes particularly
evident in the architecture of the FSA Handbook, which is conspicuously
principles-based. Considering the process of rule-formation first, FSA
must state clearly the purpose of the rules as early as the moment it
proposes to draft new rules or amend existing regulation. As soon as the
legal text is finalised, it takes the form of ‘high-level standards’, which
capture what the regulator seeks to achieve in terms of outcomes. Once the
rules become part of the Handbook, FSA’s priority changes. From clarifying
the purpose of the rules, the Authority’s main concern is now to guide the
regulated population towards a purposive interpretation of the regulatory
requirements. To this effect, ‘high-level’ statement of purpose set the tone
for interpretation. To assist the regulated population in interpreting
regulatory requirements, FSA has also put in place the so-called “Treating
Customers Fairly” (TCF) initiative. This is not a bunch of new rules. It is a
project that involves developing a common view on the rights and
responsibilities of both consumers and firms and helping senior

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90 The terms ‘principles-based’ and ‘purposive’ are used interchangeably. The adjective ‘purposive’ is
introduced here instead of the commonly used term ‘principles-based’, in order to emphasise the rationale
behind this policy (‘attaining certain outcomes’) rather than the typology of regulatory provisions that are
chiefly deployed to put it into operation (‘high-level principles’). See A. Georgosouli, above note 72, 125; S.
Wilson, ‘Supervision in a Principles Based World’, FSA Speech (27 February, 2007). In EU level there is a
similar drive for a principles-based approach to regulation. D. A. Sabalot, ‘The World Turned Upside
It will be shown below that the similarity of the two regimes is only apparent.
91 Tiner, above note 76, 2.
92 FSMA 2000, section 2 para. (1)(b) sets out that “In discharging its general functions the Authority must,
so far as reasonably possible, act in a way which is compatible with the regulatory objectives; and which the
authority considers to be appropriate for the purpose of meeting those objectives.” The Authority is under
the same duty when it comes to the issuance of guidance under section 157(3) of the Act.
93 High-level standards apply generally to authorised persons, approved persons and to senior management
and they are principles-based. At their centre stand the Principles of Business; eleven high-level principles,
which set overarching objectives for all financial services firms. J. Tiner, above note 76, 2.
94 In this manner FSA acts in accordance to section 155(2)(b) of the FSMA, which stipulates that FSA
must always explain the purpose of the rules that it proposes to put in practice. High-level statements of
purpose are found at the beginning of each section of the Handbook. Significantly, the FSA Handbook is
subject to its own rules of interpretation. To a considerable extent, these rules of interpretation deviate
from the provisions of the Interpretation Act 1978, which applies to secondary legislation.
95 S. Wilson, ‘Treating Customers Fairly –Principles-Based Regulation in Practice’, FSA Speech (7th August
2007); FSA, Towards Fair Outcomes for Consumers, (19 July 2006); C. Briault, ‘Treating Customers Fairly’, FSA
Speech (20 March, 2006); O. Page, ‘Treating Customers Fairly’, FSA Speech (16 February, 2005); and J.
management to work out for themselves what practices guarantee fair treatment for their clients especially consumers. With other words, TCF is designed to bring about cultural change all the way down at practitioner level so that financial services providers remain focused on delivering the desirable policy outcomes for retail consumers at all times. Finally, FSA enjoys plenty of scope to adjust the application and enforcement of COB rules, where this is considered necessary. For instance, FSA may decide to grant modifications or waivers provided that it is satisfied that this is the best way to promote the purpose of the regulatory requirement.96

5.4. Communicative elements

While the principles-based architecture of the FSA Handbook manifests a purposive approach to the application and enforcement of rules, the fostering of communicative elements is intended to bring the whole idea into life.97 Several aspects of the way in which regulatory requirements are formed, followed and enforced lend support to this claim.98 The distinctively participatory character of the procedure that FSA must follow in order to issue rules, the fact that FSA is in constant communication and dialogue with the regulated firms so as to ensure that its regulatory requirements are

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96 See for example FSMA 2000, section 148(4)(a). Similar consideration guides the FSA’s choice of enforcement strategy in case of contravention of regulatory requirements.
97 On the importance of communication in a principles-based approach to regulation see A. Georgosouli, above note 72, 126; and J. Tiner, note 76, 4-6.
98 The drafters of the FSMA 2000 placed great emphasis on enhancing the openness, transparency and participatory character of the FSA’s exercise of regulatory powers. In this connection, not only does section 8 of the FSMA 2000 provide that the regulator has a general duty to make and maintain effective arrangements for consulting practitioners and consumers on the extent to which its general policies and practices are consistent with its general duties specified in section 2 of the Act but the FSMA also contains a multitude of other provisions where a net of consultation procedures for specific purposes is laid down in considerable detail. One of these is section 155 of the Act, which places consultation at the heart of the rule-making process.
properly understood, the essentially discursive nature of FSA’s strategy of compliance and enforcement are but some of them.

All these communicative components perform a multitude of crucial functions. They promote flexibility and facilitate the channelling of information. They provide a forum of debate and scrutiny of the FSA’s policies. Perhaps more importantly, they deal with problems such as (a) the tendency of legal rules to regulate more or less cases than it was initially intended; (b) the uncertainty that surrounds the task of FSA to fulfil a range of broadly defined and frequently conflicting regulatory objectives; and (c) the uncertainty pertaining to the definition of complex problems where the consequences of regulatory action are hard to appraise.

The presence of communicative elements signifies that the formation, application and enforcement of rules are largely practised through the function of communities of interpreters. These are associations encompassing on the one hand, the FSA as the regulator and, on the other hand, the regulated industry, consumers as well as other interest groups. These vary in terms of composition and inclusiveness depending on whether the subject of deliberation is the formation of rules or the application and enforcement of the existing ones. Apart from providing the necessary channels for the flow of information, these associations are relied upon to cultivate the necessary psychological conditions for compliance and

100 Above note 56, at 493.
101 Above.
102 Similar problems have been addressed nearly in the same way during the earlier regimes of self-regulation and self-regulation with in a statutory framework (the Financial Services Act 1986 regime) although currently the preservation of communicative elements in financial regulation became a more conscious project.
103 Here I draw on J. Black’s account of interpretive communities although I do not strictly follow it. See above note 73, 30-31. The notion of interpretive communities in Rules and Regulators is discussed in Chapter Four below.
to help the regulated firms become conscious of their new more active and challenging role in the regulatory system.\footnote{Arguably the FSA’s policy of rule-use as currently practised pushes towards a new phase of de facto changes in the institutional lay out of the UK financial regulation. I return to this point below, when I discuss certain difficulties that pertain to the implementation of a communicative approach to rule-use.}

\section*{5.5. Risk-based regulation}

A third characteristic of FSA’s policy of rule-use is its risk-based nature,\footnote{A. Georgosouli, above note 72, 126-127.} which can be traced back to the regulator’s mandate to make sure that it lays out policies that are proportionate, economically efficient and eligible to preserve competition, innovation and the leading position of the UK in the international arena.\footnote{FSMA 2000, section 2. This general duty finds special expression in a range of other provisions in the Act. Examples include, sections 155 and 65 setting out the procedural aspects of rule formation and the procedure for the issuance of statements of principle and codes of practice under section 64 respectively, Part X, chapter III subjecting FSA’s regulatory requirements under competition scrutiny, section 148(4) stipulating that waivers and modifications are justified provided that FSA is satisfied that compliance with regulatory requirements as they stand would be unduly burdensome or would not achieve the purpose for which the rules are made.} Specifically, the formation, application and enforcement of rules are currently guided by the ARROW II framework.\footnote{ARROW stands for the Advanced, Risk-Responsive, Operating框架. FSA, \textit{The FSA’s Risk-Based Approach} (November, 2006), 3. On the evolution of the FSA’s risk-based approach to regulation see, FSA, \textit{The FSA’s Risk-Assessment Framework} (August, 2006) and; J. Black, ‘The Emergence of Risk-Based Regulation and the New Public Risk Management Regime in the United Kingdom’, \textit{Public Law}, (2005), 512-548, at 524-530. For an extensive commentary on the theoretical background and nature of the FSA’s risk-based regime see, J. Gray and J. Hamilton, \textit{Implementing Financial Regulation: Theory and Practice} (2007), chs. 1 and 2 respectively. ARROW II constitutes a revised version of the earlier risk-based framework (ARROW I). Compared to its predecessor, ARROW II concentrates the following advantages: (a) It allows a more accurate comparison of risks in different areas; (b) it makes possible for FSA to have better control of the supervisory process as well as to ensure consistency; (c) the revised ARROW assessment letters increase practitioners’ involvement in the risk assessment process, so that FSA gets a more accurate picture of the risks imposed by each firm and (d) they improve FSA’s capacity to undertake analysis work and overall become duly aware of emerging risks and other trends in the industry.} The aim of ARROW II is to provide a common risk assessment framework for all regulated firms and to promote a regulatory approach that is proactive, integrated and transparent.\footnote{As with the earlier risk-based regime (ARROW I), ARROW II is used to determine regulatory priorities and resource allocation, to assess firm-specific risk for monitoring purposes; to assess market and industry-wide risks, to determine policy objectives on annual basis; and assess possible changes in regulatory scope (e.g. additional responsibilities). FSA, \textit{The FSA’S Risk-Based Approach – A Guide for Non-Executive Directors} (November 2006) and; FSA, \textit{The FSA’S Risk-Assessment Framework} (August 2006) chapter 2 paras. 6 to 9.} ARROW II intends to interact with
the Authority’s policy of rule-use in a manner that promotes flexibility,
economic efficiency and ultimately regulatory effectiveness.\textsuperscript{109}

The risk-based framework is thought to increase flexibility\textsuperscript{110} in the sense that it allows FSA to formulate rules, and to apply and enforce them in a manner that is proportionate to the risks that each regulated firm individually or the market as a whole imposes upon the regulator's activities. Relying on ARROW II, FSA can issue generally applicable rules and later on adjust their application, for example, by regulating more extensively those firms that fail to put in place adequate systems and controls and by rewarding those firms that are successful in satisfying this requirement by way of adopting a much less intrusive regulatory attitude.\textsuperscript{111}

Moreover, it is generally assumed that the application of ARROW II promotes economic efficiency. Up to this point it is important to stress the crucial link that exists between FSA’s risk-based framework and the internal systems and control that each regulated firm puts in place to manage risk exposure.\textsuperscript{112} Due to this interdependence it is now possible for the Authority to use its own set of rules efficiently in the sense that FSA can rely on the firm’s self-regulation, once the firm’s risk assessment suggests that the firm maintains internal systems that are eligible to manage risk-exposure adequately. Costs are further reduced because ARROW II enables the Authority to direct the application and enforcement of rules only to one firm or to a sub-sector of firms. Arguably, this opens up a multitude of other cost-effective possibilities for FSA.\textsuperscript{113} Examples include the targeted use of rules (a) as a cost-effective method for clarifying the regulator’s

\begin{flushleft}
\textsuperscript{109} FSA, \textit{The FSA’s Risk-Assessment Framework} (August 2006), chapter 2 para.4.
\textsuperscript{110} Above, chapter 2 para. 5 and chapter 3 para. 33.
\textsuperscript{111} Above note 109, chapter 2 paras.13 to 20.
\textsuperscript{112} Above note 109.
\textsuperscript{113} Above, chapter 2 para.3.
\end{flushleft}
expectations and conveying its intentions for future regulatory action; (b) as a strategy that aims to create compliance incentives; and (c) as a vehicle to test its policies keeping the costs of experimentation to a small and controllable scale.

Finally, one should not lose sight of the fact that FSA’s capacity to meet its regulatory objectives depends on the following two things; first, on its ability to translate them into operational aims and second, on its capacity to launch these aims as a policy agenda that demands full acceptance, adherence and – ideally- unquestioning cooperation by the regulated population. Arguably, ARROW II helps FSA to succeed on both fronts. On the one hand, it provides a reliable framework through which the four vaguely termed FSMA objectives are rationally interpreted and become operationalised into the organisation while, on the other hand, it dresses their interpretation with the suit of unfailing scientific truth.

6. Some problems

6.1. Introduction

None of the above mentioned characteristics of the FSA’s policy of rule-use are free from difficulties. In this section, the discussion will pave the way to a detailed statement of their flaws and how these flaws may adversely affect the regulator’s performance. Although there is a considerable overlap

\[\text{Indicative of this point is the fact that FSA places great importance in fostering a shared appreciation of the regulatory outcomes that it seeks to achieve and the range of risks that threatens them. FSA, ‘The Open Approach to Regulation’, FSA Policy Statement (1998).} \]

\[\text{In light of the scientific status of ARROW II, the contingency of disobedience as a manifestation of a deeper disagreement with the regulator’s interpretation of rules becomes a remote threat and, in any case, an eventuality that is much easier to manage. J. Mayer and B. Rowan ‘Institutionalised Organisation: Formal Structure as Myth and Ceremony’, 83(2) American Journal of Sociology (1977), 340.}\]
between them, for systematic purposes the discussion is divided into four thematic parts, as many as the number of the elements of the FSA’s policy that were identified above. Towards the end of this section, special reference is made to the implementation of the MiFID in the UK, which arguably poses its own set of difficulties to FSA’s plans for a more principles-based approach to regulation.

6.2. Problems relating to the architecture of the FSA Handbook

The drafters of the FSA Handbook had a difficult task to accomplish. They had to ensure that the content of the Handbook is accessible and that the regulatory requirements are expressed in a simple language. They had to strike the appropriate balance between types of rules of varying levels of generality, abstractness, specificity and prescriptivity so as to end up with a regime that is flexible but at the same time certain and predictable. Finally, they had to ensure that the use of the Handbook is economically efficient. There are several reasons why we may question the capacity of the Handbook to meet all these aims.

Not only did the sophisticated design of the Handbook fail to deal with the problem of complexity but, in fact, it made it worse. Indeed what appears to be the end result of the present organisational structure of the Handbook is persistent complexity taking a range of different forms.\footnote{Strictly speaking neither simplicity nor clarity is an inherent feature of the Handbook. Rather they are states of affairs to be perpetually attained provided that and to the extent in which the regulator is effective in communicating the meaning of the regulatory requirements to the regulated population. A. Georgosouli, above note 72, 129-131} Paradoxically, complexity is well hidden behind those features that were originally intended to reduce it. It takes the form of new but not necessarily clear terminology; it lies behind the innumerable specialist glossaries and guidebooks; and it survives in the multitude of navigating tools surrounding the provisions of
the Handbook. The fragmented way in which the various provisions can be accessed and the lack of continuity in the text exacerbate this problem and make them difficult to read.

For example, if a firm wishes to find out whether it is subject to the Conduct of Business Sourcebook (COB), it must read COB 1.2.1 rule in combination with COB 1.3.1 rule. The trouble is that both these rules require that the reader must make frequent use of the Glossary in order to define almost every word that is contained in the text and, in addition, to refer to other parts of the Handbook or other statutory instruments (for instance COB 1.3.1 rule refers to the Financial Services and Markets Act (Regulated Activities) Order 2001 (SI 2001/544)) to make sense of the initial regulatory provision, which in turn are not designed to be read in isolation but only in conjunction with other regulatory provisions and through the help of a range of navigating tools.

FSA seems to be aware of the limited capacity of the various navigating tools to make the Handbook user-friendly. Therefore, it has set up a sophisticated communication network to help financial firms cope with the massive and fast changing body of regulatory requirements. For instance, large firms are assigned to a FSA relationship manager who is responsible inter alia to carry out an open dialogue with the firm and FSA, while small firms –nearly 90% of the regulated population- can contact the FSA Firm Contact Centre that handle inquiries about regulation and the Handbook and they can also benefit by attending regional or thematic visits of FSA representative and partaking of industry training.\textsuperscript{117} Nevertheless the effectiveness of these communicative elements in bringing about clarity, predictability and consistency in the interpretation of regulatory

\textsuperscript{117} For a detailed account of the recent developments that intend to improve FSA business capability see, \textit{FSA Business Plan 2006/2007}.
requirements has its own limitations.\textsuperscript{118}

Other flaws of the design of the FSA Handbook derive from FSA’s controversial attempt to strike a proper balance between certainty and flexibility in an economically efficient manner. It is dubious whether the drafters of the FSA Handbook were successful in this regard.\textsuperscript{119} Arguably, the balance is optimal where the combined application of high-level principles and detailed prescriptive rules does not increase the cost of compliance and does not engender competitive discrepancies. However, the possibility of discretionary enforcement and the availability of ex post facto waivers and modifications suggest that there is no guarantee that this will be observed in practice.\textsuperscript{120} Moreover the creation of economies of scale and scope in normative level may not lead to the initially anticipated cutting of costs,\textsuperscript{121} due to the ensuing complexity, the cost of maintaining a sophisticated network of communication and the top-heavy procedural benchmarks that underpin the use of rules.

\textbf{6.3. Problems relating to the purposive nature of the FSA’s policy of rule-use}

At first sight, nothing seems to be wrong with the idea of adopting a purposive approach to the policy of rule-use. Emphasis on outcomes is

\textsuperscript{118} These limitations are discussed below in a separate subsection.
\textsuperscript{119} Ever since the FSA Handbook was brought into being, the balance between high level principles and detailed rules has been the subject of constant review. See above note 74. This point is further discussed below in the context of the perceived difficulties that are associated with purposive regulation.
\textsuperscript{120} One might object that there are benchmarks to make sure that FSA gets the balance between high-level principles and detailed prescriptive rules right, pointing out that FSA is held accountable on the basis of the four statutory objectives and principles of good regulation, which inter alia require the use of cost-benefit analysis and a risk-based approach to financial regulation. This argument, however, does not impose a serious challenge to my claim, given that the content of the statutory objectives, the principles of good regulation and the implications of findings of empirical research are subject to interpretation and FSA is the ultimate arbitrator of their meaning and implications in terms of public policy. After all FSA’s cost-benefit methodology has its own flaws. In a recent report the National Audit Office suggested that FSA “needs to enhance its grip on information on the cost of its activities.” National Audit Office, \textit{NAO Report HC 500, (2006-2007) The Financial Services Authority, Executive Summary}, (April 2007).
\textsuperscript{121} Above note 9, 18-19.
welcome in light of the benefits that this policy is expected to bring with it, for example, the development of market-based solutions as an antidote to regulatory failure and the fostering of compliance with the spirit rather than the letter of regulatory requirements. However, a more careful look into the peculiarities of its implementation suggests otherwise.\textsuperscript{122}

One source of concern relates to the use of ‘high-level principles’ as the main instrument for putting purposive regulation into practice. The successful use of high-level principles –namely, rules termed in high level of generality and abstractness- relies heavily on the regulator’s capacity to clarify their content.\textsuperscript{123} Although FSA has put in place arrangements to ensure certainty and predictability, these do not always work well. The Handbook is accessible but not necessarily user-friendly. Its complex structure stands in the way of making sense of the regulatory requirements with any certainty. The numerous provisions in the form of guidance intend to clarify the content of ‘high-level principles’ but FSA’s choice to stipulate that some of them are legally binding while others are not, left the regulated community bewildered and struggling to understand how each of them interacts with ‘high-level principles’ and how they define the parameters of compliance.\textsuperscript{124} Furthermore, the open dialogue with the regulated firms – perhaps the most important means to waive obscurity and uncertainty- may not live up to FSA’s expectations due to some problems that are endogenous to the conversational and risk-based nature of the policy of rule-use, that are discussed in more detail below.\textsuperscript{125}

\textsuperscript{122} A. Georgosouli, above note 72, 131-133. The impact of the implementation of MiFID on the FSA policy of rule-use will is discussed in a separate section below.
\textsuperscript{123} S. Wilson, above note 95.
\textsuperscript{124} D. Waters, above note 99; and note 7, 48.
\textsuperscript{125} See the discussion in the relevant subsections below.
It is also suggested that the bad reception of FSA’s appetite for more reliance on high-level principles should not be regarded as a trivial matter.\textsuperscript{126} For one thing some of the industry’s concerns pertaining to FSA enforcement action on the basis of general standards are reasonable.\textsuperscript{127} For example, it is true that the gradual adoption of principles-based regulation has been coupled with a proliferation of informal guidance materials, which are published outside the Handbook and are not subject to the meticulous consultation procedure that is set out in section 155 of FSMA 2000. Similarly, it has been pointed out that both formal and informal guidance are of uncertain evidential weight. But, even if we assume that the sceptics in the regulated community are wrong in thinking that FSA’s intentions are going to open up a new era of litigation risk and uncertainty, it is suggested, that the impact of their hostile attitude on FSA’s plans to decentralise decision-making at the level of each regulated firm and encourage a non-formalistic strategy for the interpretation of rules, will be tremendous. If the FSA’s scheme is to work at all, it is essential that the regulated firms have confidence in their judgements as well as in their capacity to fairly predict the consequences of their actions. Their reaction towards the Authority’s announcement for a more principles-based approach to regulation reveals that this is exactly what they seem to lack.

Finally, the inter-relation between a purposive regulation and the imperative need to control the exercise of discretion in public administration poses its own challenges. The success of a principles-based approach to regulation is contingent to the optimal function of mechanisms that intend to aid the

\textsuperscript{126} On the industry’s reaction see above note 123; and, S. Wilson, note 95. 
regulator in making informed choices and to the effectiveness of mechanisms that purport to control FSA’s exercise of discretion when defining what outcomes are ‘desirable’ and how to attain them in an ‘appropriate’ manner. None of these mechanisms works perfectly. Their defects are transmitted into the regulatory system making principles-based regulation susceptible to failure.

6.4. Problems relating to the communicative character of the FSA’s policy of rule-use

The architects of the FSA’s policy of rule-use placed great emphasis in establishing a regime that is communicative in character. The idea was twofold: On the one hand to render the regulatory process open and transparent and on the other hand to ensure that the policy of rule-use becomes reflexive and sensitive to market developments. Common to both was the precondition that the regulated population is warmly encouraged to take a more active part in the-day-to-day regulation. Although in theory sound, in practice the adoption of communicative patterns for the formation, application and enforcement of rules is not free from problems.

The standard criticism against the introduction of communicative elements into the policy of rule-use can be summarised into the following two arguments. The first one is the claim that communities of interpreters tend to undermine regulatory accountability. Arguably, regulatory systems that are designed to increase participation and openness may operate more easily

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128 All those features of the FSA policy of rule-use that can be described as ‘communicative elements’ are examples of mechanisms that aid the regulator in making informed choices providing at the same time an additional layer of public scrutiny.

129 The risk-based approach to regulation as it finds expression in ARROW II framework is the standard example to evoke in this connection.

at the stage of rule formation rather than rule application and enforcement. Indeed, taking into account that FSA’s enforcement is compliance-oriented and that the regulatory Authority is allowed to resort to waivers and modifications, conversation is more likely to be a dialogue between the enforcement officials and the regulated firm rather than a discussion embracing a wider range of interests. This being the case, the capacity of the rest of the regulated population to monitor the regulatory process and hold the regulator accountable becomes progressively frail. The second one is the claim that communicative patterns of regulation are more likely to increase the cost of regulation rather than reduce it.\textsuperscript{131} Not only do they require the maintenance of complex networks of communication and sophisticated fora of deliberation but they also create conditions that render decision-making particularly vulnerable to regulatory capture.

These criticisms aside, there is another aspect of the communicative nature of the FSA’s policy of rule-use that is equally suspect. Arguably, the progressive reliance on communicative patterns of rule-use\textsuperscript{132} has caused an unintentional chain of evolution with respect to the way in which regulation is currently practised to the effect of transforming it into what might be described as a de facto quasi-model of deliberative democracy.\textsuperscript{133} To the extent in which this claim is valid, participatory regulation of this sort assumes something more than consulting with the regulated population, sharing information and cultivating common perceptions of what counts as ‘problem’, ‘proper mode of action’ and ‘desirable result’. It carries with it the promise that the regulator gradually steps back so as to allow the various

\textsuperscript{131} Above note 73, 42.
\textsuperscript{132} The purposive character of the FSA’s policy of rule-use may be evoked in support of this view as it clearly indicates an emphasis on meta-regulation.
interest groups (the deliberants that take part in communities of interpreters) to become themselves the arbitrators of their fate. Clearly, this would suggest a new role for FSA; that of the mediator as the facilitator of a discursive project that would enable the parties to recognise each other’s rationalities by helping create a new common language to make sense of the pathology of their relationship and what should be a proper mode of action.\textsuperscript{134}

Is FSA capable of performing this role?\textsuperscript{135} One of the key tasks of the regulator as mediator is to be able to find ways of explaining and reflecting on the different logic of each discussant in such a way that others can understand it.\textsuperscript{136} To carry out this task FSA must show a sincere commitment to be open to others’ views. It must be able to understand them and put the arguments of each deliberant into a form that other co-discussants could understand. There are several factors that stand in the regulator’s way in performing this role.\textsuperscript{137} Information, time and other constraints over FSA’s capacity to conduct debates are one of them. Another one is that public officials have their own world views that affect the way in which information is sought and understood, what is seen to be a problem requiring attention, and what solutions are seen to be appropriate.\textsuperscript{138} This means that in reality FSA may simply not be sufficiently open to other rationalities in order to understand them.

\begin{footnotesize}
\begin{enumerate}
\item[134] A. Georgosouli, above note 72, at 134-135. In practice things are far from the ideal of a scheme of deliberative democracy that would justify the communicative mode of regulation. Very frequently the regulated population is expected to tolerate FSA’s intrusive tactic to put informal pressure without being able to legally challenge FSA’s practice due to its informal character. See, for example, the decision of the Financial Services and Markets Tribunal in Geoffrey Alan Hoodless and Sean Michael Blackwell v FSA (3 October, 2003), where the firm had to terminate a range of management-level functions “due to pressure from FSA”. For a useful discussion of this case see, J. Grey and J. Hamilton, above note 107, 126-130.\item[135] In elucidating the pathology of the communicative aspects of the FSA’s policy of rule-use, I am only concerned with a question of fact: “Is the FSA capable to perform this role?” The corollary question of principle namely, whether the regulator should perform this role falls outside the scope of my inquiry.\item[136] A. Georgosouli, above note 72, at 135.\item[137] Above.\item[138] J. March and J. Olsen, ‘The New Institutionalism: Organisational Factors in Political Life’, 78 American Political Science Review (1984), 734 and; W. R. Scott, Institutions and Organisations (1995).
\end{enumerate}
\end{footnotesize}
Whatever the case, the fact of the matter is that as long as the institutional structure of FSA remains strictly hierarchical and the regulator insists to emphasise its commitment to a distinctively participatory approach to rule-use –namely, an approach that pushes towards the development of heterarchical systems of regulation- the regulated population receives mixed and contradictory messages.\textsuperscript{139} It senses that the regulator’s call for its more active involvement in regulatory practice –something that brings with it more freedom but also heavier burdens and responsibilities- and at the same time, realises that it cannot be trusted with deciding its fate for itself. Ultimately, this militates against the creation of the desirable psychological conditions to achieve the level of cooperation and compliance that FSA envisages to achieve.\textsuperscript{140} It risks disorientating the regulated community, it breeds distrust and in the long run it distorts its willingness to take part in a discursive project that requires from its regulated firm a sincere commitment to reconcile conflicting interests and work out mutually shared agendas for actions and solutions.

6.5. Problems relating to the risk-based nature of the FSA’s policy of rule-use

FSA’s risk-based framework intends to interact with the policy of rule-use in a multitude of ways. It adds flexibility in the sense that FSA’s strategy for the formation, and application and enforcement of rules becomes proportionate to the risks that firms individually -or the market as a whole- impose on the regulator’s agenda. It makes possible for the regulatory Authority to make efficient use of its own set of regulatory requirements in the sense that the FSA can rely on the firm’s ‘self-regulation’. Last but not

\textsuperscript{139} A. Georgosouli, above note 72, at 135.
\textsuperscript{140} Above note 99.
least, ARROW II provides a reliable framework through which the four vaguely termed statutory objectives are rationally interpreted and become operationalised into regulatory practice. A careful examination of the function of the FSA’s risk-based regime reveals that the risk-based approach may paradoxically have an adverse effect on the Authority’s performance.

One of the dominant features of any risk management model—and ARROW II is not an exception to this rule—is to provide a common risk assessment framework for all firms regulated by FSA.\textsuperscript{141} Homogeneity thus stands at the core of risk-based regulation.\textsuperscript{142} This feature, however, is found in striking contrast with FSA’s commitment to ensure that its policy is responsive and flexible enough to adapt to the changes of the market environment let alone to the peculiarities of each individual firm whose activities fall within the scope of FSA’s jurisdiction.\textsuperscript{143} Flexibility requires that the application and enforcement of rules take into account the uniqueness of each particular case. By contrast, ARROW II seeks to achieve uniformity in place of diversity and stipulates what should be the regulator’s appropriate mode of action once the idiosyncratic elements of each particular case have been aggregated and homogenised into a set of commensurate “risk elements” and “quantitative impact indicators” contained in the framework.

There is an additional reason explaining why the end result of a risk-based approach to the application and enforcement of rules may engender sclerosis and stiffness instead of flexibility and responsiveness. Similarly to any other risk management system, the success of ARROW II is based on the prediction of a particular type of future. To the extent in which future contingencies turn out to be different from those captured by the

\textsuperscript{141} J. Black, above note 107, 531.
\textsuperscript{142} Above.
\textsuperscript{143} A. Georgosouli, above note 72, 136.
framework, they escape the attention of the officials.\textsuperscript{144} In this manner the inability to predict, becomes institutionalised within the framework in such a way that negates the regulators’ capacity to adjust their strategy to the changing market environment.\textsuperscript{145} It is true that FSA intends to implement ARROW II in a manner that allows supervisory overrides where the regulator considers that the ensuing numerical measure is not a fair reflection of the firm’s risks and their impact.\textsuperscript{146} It is equally true, however, that it is unlikely that the regulator will put aside the ARROW II assessment and rely on his discretion for ARROW II provides him with some sort of a ‘safe harbour’ to which he can resort so that he will not be blamed in case of failure.\textsuperscript{147}

Moreover, FSA itself has recognised that the enforcement of regulatory norms on the basis of ARROW II presents major flaws.\textsuperscript{148} Due to its compliance-oriented nature, the effectiveness of FSA’s enforcement regime is contingent to the regulator’s capacity of creating incentives for compliance. This is where things go wrong. ARROW II dictates the Authority to concentrate its enforcement resources where they will have more impact. This means that FSA’s enforcement action is chiefly directed against large firms. Small firms namely, the majority of the regulated population, escape the threat of enforcement action and, consequently, they may be led to believe that they can transgress regulation without facing a serious risk of punishment. The erosion of compliance incentives is potentially a serious problem for FSA, as regular disobedience on the part of

\textsuperscript{144} On the phenomenon of ‘process-induced myopia’ see J. Black, above note 107, 543.
\textsuperscript{145} Regulators are further discouraged in light of the new politics of accountability that risk-based regulation brought with it. J. Black, above note 107, 545-546.
\textsuperscript{146} S. Wilson, above note 95.
\textsuperscript{147} On the lack of incentives to adopt an imaginative approach to regulation see more generally, M. Sparrow, \textit{The Regulatory Craft} (2000) at 310; and N. Gunningham and P. Grabosky, \textit{Smart Regulation} (1998).
\textsuperscript{148} See above note 74.
small firms is bound to cause the resentment of compliant firms and engender regulatory arbitrage.

Finally, the claim that the risk-based nature of FSA’s policy of rule-use aids economic efficiency is flimsy.\textsuperscript{149} This point becomes plain once we consider the interdependence between FSA’s risk-based approach and the firms’ internal systems and control.\textsuperscript{150} Specifically, the argument that FSA can make efficient use of its own set of rules by relying on the firms own self-regulation\textsuperscript{151} assumes inter alia that the regulator and the regulated firm share a common understanding of the objectives that must be pursued and of the risks that must be combated. But this is hardly the case.\textsuperscript{152} The firm’s internal controls are directed at ensuring that the firm achieves profits and market share that is, objectives different from those of the regulator. Despite the fact that many steps have been taken towards promoting some sort of revision of the objectives that each firm’s internal systems and control are set up to achieve, so far the end result is not impressive.

6.6. The implementation of the Markets in Financial Instruments Directive (MiFID) and its impact on the FSA policy of rule-use

The Markets in Financial Instruments Directive (MiFID) is regarded by many the cornerstone of the European Union’s Financial Services Action Plan.\textsuperscript{153} It comprises four levels of European Legislation.\textsuperscript{154} (a) “Level 1”

\textsuperscript{149} A. Georgosouli, above note 72, 136-137.
\textsuperscript{150} S. Wilson, above note 95; and J. Braithwaite, note 134.
\textsuperscript{151} On self-regulation see, B. Morgan and K. Yeung, \textit{An Introduction to Law and Regulation} (2007), 92-96.
\textsuperscript{152} Above note 56, 505.
\textsuperscript{154} The MiFID was the ‘child’ of the Lamfalussy legislative process, which aimed at maximum harmonisation and the increase of transparency of the legislative process in the EU. On the Lamfalussy process see M. Ortino, ‘The Role and Functioning of Mutual Recognition in the European Market of Financial Services’, 56(2) \textit{International and Comparative Law Quarterly} (2007), 309 at 318-322; N. Maloney, ‘Financial Market Regulation in the Post-Financial Services Action Plan Era’, 55(4) \textit{International and
that is the Directive itself;\(^{155}\) (b) “Level 2” which refers to various measures that were subsequently taken in the form of Directives and Regulations with the view of facilitating the technical implementation of the Directive;\(^{156}\) (c) “Level 3” comprising non-binding guidance and common standards, whose chief objective is to ensure the coherent implementation of MiFID and consequently the new conduct of business rules\(^{157}\); and (d) “Level 4” which constitutes a range of initiatives that seek to monitor the effective implementation of EU legislation in national level.\(^{158}\) MiFID brings about significant changes in order to reflect developments in the field financial services and markets since the implementation of its predecessor Investment Services Directive (ISD). It broadens the range of “core” investment services and activities that firms can passport, it clarifies the allocation of responsibilities between home state and host state, it requires firms to comply with certain capital requirements and, overall, it increases harmonisation by setting out detailed requirements governing the firms’ organisation and conduct of business.\(^{159}\)


The implementation of MiFID in the UK has offered an occasion for FSA to review the design of the Handbook and rebalance the overall mixture of high-level principles and more detailed rules.\(^{160}\) The NEWCOB, which will soon replace the existing FSA Conduct of Business Sourcebook, is expected to be simpler and shorter in terms of its design. Its structure will be chronological in order to reflect the successive stages of a firm’s relationship with its clients starting with marketing, moving on to the point where a contract is made and so on. Furthermore, in relation to certain issues, specialist material will be brought together to make it easier to use for reference purposes, whereas other materials will be removed to more appropriate places.\(^{161}\)

In addition, the NEWCOB will be the first major part of the FSA Handbook to come into force once revised in accordance with principles-based regulation.\(^{162}\) In this connection, it is worth pointing out that despite the keenness of the MiFID drafters to adopt a principles-based approach\(^{163}\) to regulation, their perception of what counts as a ‘principles-based’ policy of rule-use diverges from that of FSA.\(^{164}\) Take the example of the FSA


\(^{161}\) Regulatory provisions dealing with distance marketing and with-profits are examples of areas in which specialist materials will be brought together. Regulatory requirements on managing conflicts of interests are examples of regulatory provisions, which will no longer be part of the FSA Handbook on Conduct of Business. These will be removed to SYSC. See also the discussion in section 6.6 of Chapter One above.

\(^{162}\) As Dan Waters—the Director of the FSA Retail Policy Division—put it: “We consider NEWCOB to be our flagship project for more principles-based regulation”. D. Waters, ‘NEWCOB and More Principles-Based Regulation’, FSA Speech (January/February, 2007).

\(^{163}\) D. A. Sabalot, ‘The World Turned Upside Down: Radical Ideas In Regulation’, 21(4) Journal of International Banking and Financial Law (2006), 147. The nature of the policy of rule-use that has been adopted by EU rule-making bodies during recent years cannot be discussed here in detail. Suffice is to point out, however, that the move towards some sort of a ‘principles-based approach’ to rule-use—at least in theory—is evident in several features of the Lamfalussy process as, for example, the attempt to include within a single legal instrument (Level 1 measure) a framework of principles—the so-called “essential elements”—of the proposed regulatory regime, the emphasis on openness and transparency and the use of informal means (e.g., guidance) to ensure consistent implementation of EU legislation in domestic level. See E. Ferran, above note 153, 82-84 and 99-100.

\(^{164}\) N. Maloney notes that the “most dramatic operational change from the ISD regime …concerns the new conduct of business regime (Articles 19, 21 and 22). The skeletal set of principles in Article 11 of the ISD has been replaced by a highly detailed conduct of business regime, which has been further amplified at level 2.” N. Maloney, above note 158, 984-985; B. Penn, note 159, 341; B. Penn, ‘Markets in Financial Instruments Directive (MIFID): Conduct of Business’, 22(1) Journal of International Banking and Financial Law (2007), 20; and, A. Sykes, ‘NEWCOB: The Practical Implications’, FSA Speech (19 June, 2007), where he
Treating Customers Fairly (TCF) initiative. It was pointed out earlier that TCF relies heavily on informal means and aspires to bring about cultural change at practitioner level to the effect of changing the firms’ attitude towards their unsophisticated clients. One would expect that a similar initiative exists in EU level but this is far from true. A plethora of MiFID rules, including those of conflicts of interest and best execution lay out a net of detailed and prescriptive regulatory provisions, which seem to be completely at odds with TCF. What is more, FSA’s principles-based approach is further eroded by the presence of ‘Level 2’ measures, whose aim is to refine the already detailed MiFID requirements leaving little –if anything- to be decided by the national regulator.

The presence of essentially two distinct principles-based approaches to regulation should not be treated as a trivial matter. On its surface it appears to be just a problem of how to deal with the industry’s concerns that the implementation of the MiFID will trigger legal uncertainty and a significant increase in the cost of regulation, to which FSA has responded by adopting the practice of “intelligent copy out” as a method of bringing the requirements of the MiFID into the UK jurisdiction. At a deeper level, however, things are much more perturbing. The Lamfalussy reform has

admits that “very often directives contain many detailed rules, which we have to copy-out into our Handbook to avoid imposing any unintended additional obligations.”

The fact that the FSA report published in July 2006 on ‘Treating Customers Fair Outcomes for Consumers’ does not mention MiFID legislation is supportive of the claim that we are dealing with two parallel initiatives running alongside each other but without interacting.

Article 13(3) of MiFID and Chapter II, section 4 of the Implementing Directive.

Section 21 of MiFID is clearly process-oriented rather than outcome-focused. See also Chapter III, section 5 of the Implementing Directive.

FSA has officially recognised that the implementation of EU legislation is one among other constraints in moving towards a more principles-based approach to regulation. FSA, Principles-Based Regulation: Focusing on the Outcomes that Matter, FSA Policy Statement (April 2007), 20-21.

For example, firms will have to spend a considerable amount of time and resources re-writing their conflict of interests’ policies and develop procedures in accordance with MiFID requirements.

Intelligent “copy out” is thought to be desirable because it reduces discrepancies between EU and national legislation, preserves legal certainty and promotes maximum harmonisation throughout EU. Furthermore, it is a safe way for FSA to ensure that its rule making is in conformity with article 4 of the Implementing Directive, which imposes certain constraints over the regulator’s rule-making function in order to deter any attempt to “gold-plate” the Directive.
pushed forward the centralization of financial services regulation, to the effect of decreasing the scope of jurisdictional competences and responsibilities of national regulators. FSA is not an exception to this rule. The UK regulatory Authority must conform to EU stipulations, which the more process-oriented and detailed they become the more they circumscribe FSA’s discretion when designing regulatory provisions and deciding the appropriate mode of interpretive strategy. Indeed, for as long as EU institutional developments envisage national regulators in the role of supervisor rather than in the role of policy maker and rule-maker, FSA’s capacity to reap in full the perceived benefits of its policy of rule-use will be limited.

7. Conclusion

This chapter explored the latest phase of the policy of rule-use in the UK financial regulation, as it was fleshed out soon after the emergence of the Financial Services Authority and the publication of FSMA 2000. Three stages of evolution were identified. During the first stage, its architects defined the design-objectives and design-principles of the FSA Handbook. During the second stage, they set out in more detail the typology of rules that were going to be used by the Authority as well as the nature of the policy of rule formation, application and enforcement. The preparatory

171 Arguably, this has gone too far. The choice to introduce “Level 2” measures in the form of Regulation raises concerns that the principles of Subsidiarity and Proportionality -as envisaged in paragraph 6 of Protocol 30 of the EU Treaty- are unduly infringed. See E. Ferran, above note 153, 70-71 and 99-100; M. Ortino, note 154, 318-319. The problem does not stop there. It is also evident in “Level of 1” measures at least to the extent in which the nature of Directives, as legal instruments that are supposedly tailor-made to allow significant scope of manoeuvre for Member-States as to the means of implementation, is distorted by the systematic and occasionally deliberate inclusion of detailed and process-oriented provisions alongside provisions incorporating the framework principles of the proposed legislation. Y. V. Avgerinos, ‘Essential and Non-Essential Measures: Delegation of Powers in EU Securities Regulation’, 8 European Law Journal (2002), 269, at 271-283.

work entered its third phase with the integration of financial regulation into a single normative framework—the FSMA 2000—and the emergence of the FSA Handbook of Rules and Guidance.

All these developments set the basis for a policy of rule-use that comprises currently four elements. The first element is the sophisticated architecture of the FSA Handbook, which manifests itself in the extensive use of regulatory provisions that are termed in high level of abstractness and generality, the complex and fluid structural inter-relation of the regulatory norms and the plethora of navigating tools that aim to make the Handbook user-friendly and accessible. The second element is the purposive (“principles-based”) approach to rule use, which means that the FSA produces, applies and enforces rules in a manner that is essentially outcomes-oriented. The third element of the FSA’s policy of rule-use is its communicative nature that is, the distinctively participatory dialectical practice that underpins the use of rules and, finally, the fourth element is the risk-based approach, which makes possible the proportionate and cost efficient issuance of new rules or modification of the existing ones as well as the adoption of a targeted and commensurate compliance and enforcement strategy.

The FSA policy of rule-use is in theory sound. While the sophisticated design of the rules and their legal framework is expected to make rules more accessible and easy to understand, purposiveness is anticipated to foster compliance with the spirit rather than the letter of the regulatory norms, encourage the development of market-based solutions and reduce the cost of rule-use. Similarly, the inclusion of communicative elements in the policy of rule-use and the adoption of a risk-based approach were intended to cement the participatory and reflexive nature of the Authority’s policy of rule-use in an economically efficient manner.
In practice, however, the use of rules has proved to be problematic. The Handbook remains complex and hard to read - let alone make sense of. The emphasis on high-level principles tends to tip the balance in favour of flexibility and at the expense of certainty and predictability. It is also unlikely to reduce the cost of regulation because it involves the maintenance of a costly communication network. Purposiveness precipitated the creation of a new climate of risk and uncertainty, while an additional source of concern is that its effective implementation is particularly exposed to the perceived flaws of discourse-practices and other accountability mechanisms with which it interacts. The adoption of communicative style of rule-use triggers conditions of regulatory capture, and - to the extent it pushes institutional developments towards heterarcical structures of governance - breeds problems of cooperation and coordination. ARROW II may not aid the Authority in using rules in a proportionate, targeted and efficient manner not least because future risks may turn out to be different from those predicted. Finally, the implementation of MiFID is considered to be an additional source of constraints holding back FSA’s plans for innovation and experimentation.

Taking all these considerations into account, it is suggested that the current FSA policy of rule-use brings little new in terms of the objectives that must be achieved. Financial regulators in the UK have always sought flexibility, certainty and predictability, clarity and economic efficiency and for nearly two decades they have been consciously trying to direct the interpretive strategy of the regulated population towards adhering with the spirit rather than the letter of the regulatory requirements.\textsuperscript{173} That said the major difference between the present and the past regulatory practice lies in the

\textsuperscript{173} Above note 73, ch.3
ways in which these objectives are brought into fruition. Under the FSA regime, all these goals are pursued through novel means, which signal out the emergence of an interpretation-centric approach in the policy of rule-use.

As the analysis revealed, traditional patterns of self-regulation have been transformed into a sophisticated regime of meta-regulation, where the balancing of policy objectives as conflicting as certainty and flexibility is pursued by way of managing the interpretive process of rules per se rather than by way of opting for different combination of rule-type and rule-restructuring. To this effect, the de-centralisation of interpretive decision-making has been so immense that regulatees have a much more active and indeed burdensome role to perform in making sure that they regulate themselves properly. To assist them in this challenging task, FSA officials have started to change the way in which they perceive their role. In the FSMA era ‘being a regulator’ resembles to being in the role of a facilitator of a complex network of communication, which is interpretive in nature and whose aim is twofold: to explicate, review, and rework the essence of regulatory norms; and to bring about cultural change as to what it means ‘to be regulated’ and what it is like to ‘abide by the rules’. Contrary to what one would expect from a statutory-based system of regulation, ‘being regulated’ and ‘abide by the rules’ are now discharged from any connotations of passive adherence with exogenous commands coming directly from the above. More than ever before, the regulated population is asked to work out for itself and on ad hoc basis what it is like to internalise basic moral norms into its business, and it is deemed capable to become cognisant of the collective responsibility that its active participation in regulation entails.

FSA elaborated a policy of rule-use that institutionalises the dynamic inter-relation in which legal interpretation and social context is found. Behind this development lies the assumption that ‘what an FSA rule requires’ is not a static property of the text of the legal rule but an end-result to be perpetually worked-out rather than discovered.
For the moment the FSA policy of rule-use is still in progress. However, a clearer insight into its nature allows this conclusion To the extent in which the postponement of the interpretive shift in the policy of rule-use is not a realistic option, the success of this policy depends on the willingness of the regulated population to change the way in which it perceives ‘how it would like to be regulated’ under the new regime, the readiness of the regulator to redefine its institutional structure in order to mirror the heterarchical process of regulatory deliberation that has started to come into sight in the ways in which it makes use of rules, and the willingness of EU policymakers to embrace a more UK-like approach to financial regulation.
PART II – THE NATURE OF REGULATORY INTERPRETATION AND THE RATIONALE FOR THE INTERPRETIVE SHIFT IN THE POLICY OF RULE-USE
CHAPTER FOUR

The Communicative Theory of Regulatory Interpretation

1. Introduction

Part I of this thesis examined the development of the policy of rule-use in the UK financial regulation, making special reference to the FSA conduct of business regime. It was argued that the policy of rule-use has been transformed into an (quasi) interpretation-centric regime. In Part II, the attempt will be made to shed light on the grounds for this policy development by considering the nature of interpretation in the regulatory context (regulatory interpretation).¹

Although studies on regulatory interpretation are rudimentary when compared with the length and sophistication of scholarly inquiry on rulemaking, enforcement, rule type and discretion in public administration, it is suggested that the first seeds for a theory of regulatory interpretation can be found in the current literature.² In the field of financial regulation the work of Julia Black is a prominent one with this regard. Building on a jurisprudential and linguistic analysis of rules, she develops in Rules and Regulators a thesis for the nature of rules to spell out their limitations and to


² See above, Introduction.
propose ways in which rules could be used more effectively. It will be argued however that the author does more than that. Her thesis offers key insights into the practice of interpretation, which –when put together- can help us answer questions that are intrinsic to any inquiry into the justification of the interpretive shift in financial regulation, such as questions about the subject of interpretation (The interpreters’ utterances? The text of the rule?), its objective (That rules are correctly interpreted? To attain a sort of consensus?), and the presence of constraints (The prevailing ideology of a particular community of interpreters? The legal text?). My task then is to bring these insights together and assemble the theory of regulatory interpretation that emanates from her claims.

This chapter has two aims. The first one is to familiarise the reader with Black’s thesis on the nature and use of rules. The second one is to illuminate the theory of regulatory interpretation that ensues from her claims and account for its merit. Before moving on, I should make clear that this chapter is almost entirely expository. This means that it may not necessarily get Julia Black right. Rather its ultimate objective is to elicit from her analysis, what -I think- makes a very interesting description of regulatory interpretation. In terms of structure, the chapter is divided into two parts. Below I start with a very brief overview of Rules and Regulators where Black advances her account of the use of rules in financial regulation and, then, I discuss in more detail the theoretical part of her thesis. Using this as a background, in the second part of this chapter, I unfold those underlying assumptions that provide the first materials for a theory of regulatory interpretation.

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3 Progressively, the discussion will become more and more focused on her theory of regulatory interpretation.
It will be suggested that the theoretical account of regulatory interpretation that emerges from her work is *communicative* in nature. According to the communicative thesis of regulatory interpretation the practice of interpretation in the regulatory context is similar to the method of interpretation that we deploy when we try to understand our co-discussants in the course of a conversation. On that view, interpreting rules equals to communicating each other’s beliefs about how regulatory requirements should be understood; it is an opportunity for sharing information and for bridging differences through persuasion.

Although the communicative thesis places emphasis on the communicative aspect of regulatory practice, it should not be confused with Black’s argument for the adoption of a “conversational model of regulation” and her writings on “regulatory conversations”. This is because it differs in terms of subject matter, aim and theoretical foundation. Whereas I focus on the nature of interpretation in regulatory settings and consider issues such as the source of authority and the point or purpose of regulatory interpretation, Black’s field of inquiry is the institution of regulation in general and its effective operationalisation. Similarly, whereas my distinction between the communicative thesis and the constructive thesis of regulatory interpretation is based on Dworkin’s distinction between conversational and constructive accounts of interpretation in law and adjudication, Black’s work is informed inter alia by discourse analysis.

In *Rules and Regulators*, the author offers an analysis of the regulatory regime under the Financial Services Act 1986. For the purposes of this chapter and

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5 On Dworkin’s distinction see note 107 below. The reasons for using the term “communicative” instead of “conversational” in developing the theoretical counter-part of the constructive thesis of regulatory interpretation are also discussed in the Introduction of this thesis and particularly at page 23.
taking into account the ramifications of Professor Black’s thesis to our understanding of the current regulatory regime, I use the more general terms ‘regulatory Authority’ and ‘regulator’ interchangeably when referring to the institutional scheme that is delegated with the power to produce, apply and enforce rules as well as the discretion to decide matters about the policy of rule use.

2. Background

2.1 Brief overview of ‘Rules and Regulators’

*Rules and Regulators*\(^6\) engages with the traditional debate about rules in administrative law. It complements earlier work on discretion and enforcement\(^7\) and on rules, discretion, and adjudication as mechanisms for public policy implementation.\(^8\) Its aim is threefold.\(^9\) The first one is to develop an understanding of the nature of rules in order to propose ways in which rules could be used effectively in the regulatory process. The second one is to enrich this analysis with examples taken from the regulation of financial services in the pre-FSMA era. The third one is to understand the nature of rule making in the regulatory domain in greater depth. Her analysis draws together H. L. A. Hart’s analytic jurisprudence\(^10\) and the work of modern contextualists, such as Stanley Fish.\(^11\) To a certain degree, it bears

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\(^9\)Above note 6, at 2.
similarities with the New Chicago School\textsuperscript{12} and further contains the first seeds for applying discourse analysis\textsuperscript{13} to the study of legal rules in the context of financial regulation.

As Laurence Lessig observes, Julia Black considers issues as diverse as the following: “(1) the selection among rule-types; (2) the strategic and non-strategic use of rules; (3) non-instrumental values that might be advanced in the selection of particular rule-types; (4) the trade-off between rule-types and the formation of different interpretative communities; (5) the use of rule-types to help construct interpretive communities; (6) the use of strategies to develop thicker interpretive communities…; (7) the institutional and market constraints on the possible functioning of rules, and (8) the interests that rules themselves create and the dynamic induced by that creation.”\textsuperscript{14} In terms of structure, the theoretical part of her inquiry into the nature and use of rules in the regulatory context is developed in the first chapter while the empirical part occupies the rest of the book that is chapters two to five where examples are drawn on the regulation of conduct of business in the UK financial industry under the Financial Services Act 1986.\textsuperscript{15}

\textsuperscript{12} One of the main postulates of the New Chicago School is that alongside the typical modalities of regulation –namely, norms, the market and law– figures a fourth modality; the architecture within which regulation functions. L. Lessig, \textit{Code and Other Laws of Cyberspace} (1999) and ‘The New Chicago School’, 27 \textit{Journal of Legal Studies} (1998), 661.

\textsuperscript{13} Discourse analysis is among the most vast and least defined areas of linguistics with numerous applications in a wide range of disciplines. It considers how language enacts social and cultural perspectives and identities or –to put it simply– how language is organised and manipulated to convey information about the world, the speaker and the speaker’s social relationships. One of the most well-known discourse theories is the one developed by Jürgen Habermas according to which, social order is contingent to the capacity of actors to recognise the intersubjective validity of the different claims on which social cooperation depends. D. Schriffin, \textit{Approaches to Discourse} (1994); J. P. Gee, \textit{An Introduction to Discourse Analysis} (2000); J. Bohman and W. Rehg, ‘Jürgen Habermas’, \textit{Stanford Encyclopedia of Philosophy} (2007) [available at: www.plato.standford.edu/entries/habermas/#HabDisThe]; and J. Black ‘Regulatory Conversations’, 29 \textit{Journal of Law and Society} (2002), 163.


\textsuperscript{15} Above note 6, 2-3.
One of the core ideas in her analysis is the view that the function of rules depends on their content as much as on their sociological context within which they are interpreted and applied.\textsuperscript{16} The assertion that there is an indispensable link between rules and context shows that the structure of rules plays an ancillary role in the demand for certainty; what is important is to ensure that rules are clear to the regulatees. Now given that clarity is a function of the interpretation that a rule receives from a particular community, the policy of rule use should focus on how to establish conditions that encourage a shared understanding of rules. Thus cultivate a relationship of trust and ensuring that an on-going dialogue is always maintained becomes of particular importance. This has significant implications in terms of institutional design. It involves the creation of interpretive communities,\textsuperscript{17} the adoption of conversational style of

\textsuperscript{16} The interaction between meaning and social context signals out the affiliation of Black’s analysis with conventionalism, the stream of thought that emphasises the inter-relation between a practice and its social context. Conventionalists hold that we understand a concept –not when we grasp some fact but- when we are able to successfully use that concept within a language game of a given social context. Furthermore, they posit that truth is a function of the agreement of those participating within a practice and not the other way around for there is “nothing out there” in the world to be discovered and if there were we could not possibly know it. Legal conventionalism, in particular, is the school of thought according to which a legal system cannot be sustained unless those practising law see themselves as working together for the purpose of achieving coordination or for the bringing into fruition of a joint endeavour. Conventionallism is associated with the latter writings of Ludwig Wittgenstein and according to some commentators including Herbert Hart himself it permeates legal positivism. L. Witgenstein, Philosophical Investigations (G. Anscombe trans 1953); O. Fiss, Conventionalism, 58 Southern California Law Review (1985), 177; and H. L. A. Hart, The Concept of Law (1994) at 137, where he explicitly concedes that “the rule of recognition” is conventional in nature. For a different account of the nature of the rule of recognition see J. Dickinson, ‘Is the Rule of Recognition Really a Conventional Rule?’, 27 Oxford Journal of Legal Studies (2007), 1. On legal conventionalism see, D. Kyritis, “What is Good About Legal Conventionalism?” 14 Legal Theory (2008), 135.

\textsuperscript{17} The notions of “community” and “interpreters” are here broadly conceived. Apart from the regulator, the financial firms conducting business in the retail financial sector and consumers, they virtually include any interest - group that takes part in or may affect or be affected by the interpretive decision-making in the regulatory context. As it will become clear later, the term “community of interpreters” (used interchangeably with the term “regulatory interpretive community” unless otherwise stipulated) connotes that one belongs to a distinct community of interpreters not as a result of a shared understanding of the regulatory norms, but in light of a shared commitment to make the best possible sense of the object of interpretation. In this sense it differs from the notion of “(regulatory) interpretive community” as conceived in Julia Black’s work (discussed below). Similarly, the notion of “interpretive communities” suggested here differs from the concept of “interpretive communities” as it was originally elaborated in the writings of S. Fish. This is also discussed in various places below, particularly, at page 168 and note 63 as well as notes 27 and 45 of Chapter Five. Progressively the terms “community of interpreters” and “(regulatory) interpretive community” will be replaced with the broader term “regulatory community”.

regulation and the closing-off of the regulatory system from external interference.\(^{18}\)

Having this as a background, she studies rulemaking in financial regulation under the regime of the Financial Services Act 1986. In this regard, she offers an insightful description of the ways in which rules have been used and how their inherent limitations have been addressed. Finally, she proposes that the findings of her study in the field of financial regulation may be applicable to other areas of regulation and may form the basis for developing a positive theory of rule making.\(^{19}\) In the remaining sections I focus on the first chapter of *Rules and Regulators*, where the author develops her thesis on the use of legal rules in financial regulation and considers the nature of rules, their limitations and how rules could be used more effectively.

### 2.2 The nature of rules and their limitations

Julia Black offers a fresh analysis of the nature of rules.\(^{20}\) Drawing on the linguistic nature of rules, she attempts to answer the following questions:\(^{21}\) What kind of statement do they express? Are legal rules meaningful? Do they admit of an objectively ‘correct’ or ‘real’ meaning? What is the mechanism for attaching meaning to legal rules? With regard to the first question the answer is rather straightforward. Legal rules are “entrenched authoritative statements, which are meant to guide behaviour, be applied on an indefinite number of occasions, and have sanctions attached for their

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\(^{18}\) Closing-off the regulatory system is considered essential for otherwise there is an increased risk that the court’s interpretation upsets the shared understanding of rules that supposedly holds among the members of the regulatory community.

\(^{19}\) These are (a) the importance of the design of the regulatory system, (b) the significance of the market context, (c) the circumstances in which interpretive communities can be built and (d) the relevance of the regulatory system’s evolution. Above note 6, 247.

\(^{20}\) Above note 6, 2.

breach”.\textsuperscript{22} As a result of the authoritative element of legal rules, law has developed its own rules of interpretation.\textsuperscript{23} In connection to the second question, Julia Black asserts that rules have meaning; she explains, however, that whether they admit of objectively ‘correct’ or ‘real’ meaning is an irrelevant question for the purposes of discussing the nature of rules.\textsuperscript{24} By contrast, what is important is to inquire into how meaning is attached to rules in practice. In this relation, she follows the conventionalist school of thought, according to which meaning is constituted by interpretation, which in turn is a function of varying combinations of shared understandings, knowledge of language, conventions and context.\textsuperscript{25} Based on these observations, Julia Black spells out the inherent limitations of legal rules.\textsuperscript{26} These are their tendency to be over- or under- inclusive, their indeterminacy and their interpretation. A legal rule is under- or over-inclusive where there is an imperfect match between the rule and its purpose.\textsuperscript{27} This mismatch can occur for a number of reasons as, for instance, where the use of general terms “suppresses properties that may subsequently be relevant or include properties that may in some cases be irrelevant”.\textsuperscript{28} The indeterminacy of rules arises from the nature of language, the anticipatory nature of rules and the fact that rules rely on others for their application.\textsuperscript{29} Echoing Hart’s legal positivism, Black contends that a peculiar

\textsuperscript{23} See above note 6, at 17; and G. Graff ‘ “Drop Dead,” “Keep Off the Grass” and Other Indeterminacies: A Response to Stanford Levinson’, \textit{60 Texas Law Review} (1980), 405 at 411.
\textsuperscript{24} Above note 6, 14-15.
\textsuperscript{25} Above note 16. Concerning the question as to whether rules admit of objectively correct interpretation, writers adhering the conventionalist school of thought express different views. S. Fish, \textit{What Comes Naturally} (above note 12) as opposed to D. Davidson, \textit{Subjective, Intersubjective, Objective} (2001). This point is further discussed in Chapters Five and Six below.
\textsuperscript{26} W. Twining and D. Miers, above note 22, ch. 5.
\textsuperscript{27} Ideally a legal rule should be inclusive that is, the general authoritative statement that is contained in the rule and its purpose should be in congruence. Above note 6, 7-8.
\textsuperscript{28} Above at 11; and F. Schauer, \textit{Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life} (1992), 35.
\textsuperscript{29} On the indeterminacy of rules, see above note 6, at 10-11. For once again the author echoes Professor Hart and his view of partial indeterminacy. H. L. A. Hart, note 10, 125; and note 21, 18.
feature of rules is their ‘open texture’. Apart from their “core meaning” - that is, particular fact situations that clearly fall within the scope of the paradigm case- there is always a “penumbra of uncertainty” surrounding them. Indeterminacy, however, occurs, not because the meaning of the word is unclear in itself, but because in applying the rule the question will always arise as to whether the general term used in the rule applies in this particular fact situation. Agreement can remedy this problem but only to some degree. The practical impossibility to predict all feature events suggests that legal indeterminacy is permanently present. Interpretation - that is, the process through which rules are followed and applied-complements the list of features that trim down the effective use of rules. In this connection Julia Black points out that rules are only as good as their


31 Julia Black follows Hart’s famous distinction. It should be noted, however, that many commentators regard this distinction problematic. Hart hopes to explain the difficulties in the interpretation of legal rules by assuming that a word will have a single core meaning. The trouble is that in practice there is a number of possible meanings that could be taken as the “core meaning” of a rule. H. L. A. Hart, above note 10, 124-6; ‘Positivist and the Separation of Law and Morals, 71 Harvard Law Review, (1958), 593 and; I. McLeod, Legal Theory (2007), 87-88.


33 Following Wittgenstein’s thesis on unreflective rule-following, J. Black stresses that agreement helps effective rule following but it is not a condition of correctness. This seems to be at odds with a claim she makes later on, when she discusses the idea of interpretive communities, arguing that correct interpretation ‘correct’ within quotes- is the interpretation that is accepted (that is, agreed upon) by the community of interpreters. See above note 6, 30-37. On unreflective rule following see, L. Wittgenstein, Philosophical Investigations (G. E. M. Anscombe trans.) (1953) paras. 185-242. An insightful commentary on Wittgenstein’s thesis on rule following and further references can be found in A. Bileztki and A. Matar, ‘Ludwig Wittgenstein’ (November, 2002) Stanford Encyclopaedia of Philosophy [www.plato-standford.edu/entries/wittgenstein/#Phi]

34 Even the ‘core meaning’ of the rule may not be as determinate as Hart suggested. The source of the problem is that the boundaries of the category of the paradigm case are not always determinate. Language contains ‘family resemblance’ concepts, in which the category borders could change depending on the context in which it is used. G. P. Baker and P. M. S. Hacker, Wittgenstein Understanding and Meaning (1980), 320-43. It is also argued that some terms are intrinsically vague so that there are no boundaries between when the term applies and when it does not. R. M. Sainsbury, ‘Is there a Higher Order Vagueness?’, 41 Philosophical Quarterly (1991), 167.
interpretation. Rules “cannot apply themselves; they rely on others for their application.” Accordingly, they need a sympathetic and informed audience, “that is one, which understands the context of assumptions and practices in which the rule is based, which gave rise to it and which it is trying to address”.

The social dimension of the process of interpretation also implies that there is a definite link between the meaning attributed to the rule and the social context in which those involved in the project of interpretation live in, influence and are influenced by. A range of consequences arises out of this connection. The first one is that “a rule has a ‘literal’ or ‘plain’ meaning” when “participants in a community would unreflectively assign to it.” The second one is that there is no objectively clear rule or objectively plain case. Rather the clarity of a rule is a function of agreement within an interpretative community. Finally, the third one is that legal certainty is not solely a function of the rule itself but it is a function of the community interpreting the rule.

2.3. Ways to use legal rules effectively

35 By saying that “a rule is as good as its interpretation” Julia Black does not have in her mind an interpretation that must be (objectively) correct. As she categorically makes clear, when theorising about the use of rules in financial regulation and their effectiveness we are not concerned with their “meaning per se, and whether there is an objectively ‘correct’ or ‘real’ meaning….” Above, note 6, 15. Later on, I will return to this point in order to consider the implications of this claim with respect to the nature of regulatory interpretation.

36 Above note 6 at 12.

37 Above.

38 Above note 6 at 15-17. The author draws on Wittgenstein’s writings concerning unreflective rule following in mathematics and language who argued that automatic, unreflective rule-following arises from shared judgements in the meaning and application of that rule. Above note 33. The same description of “plain cases” was adopted by H. L. A. Hart. Hart, above note 10, 123.

39 Above note 6 at 18. The author follows Stanley Fish who argued that agreement is a function of the fact that interpretive assumptions and procedures are so widely shared in a community that the rule applies to all in the same (interpreted) shape. S. Fish, Doing What Comes Naturally, above note 11, 122. It is worth noticing that, contrary to Stanley Fish, Black does not regard agreement or consensus as prerequisites for correct interpretation. In her view, agreement simply facilitates the smooth application of rules. Above note 34.

40 Above note 6 at 18-19.
The overview of the first chapter of *Rules and Regulators* would be incomplete, if it did not include a brief discussion of the ways in which the inherent limitations of rules may be addressed. According to Black, one of the main obstacles that stands in the way of making effective use of rules is the almost insurmountable difficulty to reconcile contradictory policy objectives: on the one hand, flexibility and certainty and, on the other hand, adaptability and inclusiveness. How is it possible to address this problem? She argues that a compromise can be achieved by using different types of rules, by encouraging the creation of a regulatory interpretative community and by adopting a conversational style of regulation.\(^{41}\)

According to the prevailing view in the literature, legal norms can take two forms. They can be either rules or standards.\(^{42}\) Rules are usually seen as relatively precise formulations. Standards are described, as less precise authoritative prescriptions, which require some judgement for their application. Julia Black rejects this pattern of analysis. Although a detailed discussion of the reasons for her dissatisfaction fall beyond the purpose of this chapter, these can be summarised in the statement that the traditional approach fails to capture the multi-dimensional nature of rules and embraces a simplistic method for resolving the tension between conflicting policy objectives.\(^{43}\)

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41 Above 24-44.
43 For a detailed account of the problems associated with the traditional distinction of legal norms between rules and standards see above note 6, 20-24.
Black proposes an alternative model of analysis. She identifies four dimensions of rules: “the substance and scope of a rule; its character; its legal status and the sanction attaching to it; and its linguistic structure.”

The substance of the rule is its operational facts or factual predicate. Its scope is a function of the relationship of the operational facts to the rule’s purpose. The term ‘character’ refers to the consequence of the rule, which can be mandatory, directory, discretionary or permissive. “The third dimension of status and sanction reflects the context of the present analysis of rules, viz. the use of rules in a regulatory system.” Indeed, rules may be of direct or indirect legal effect, they may be embodied in a statutory instrument or be part of a voluntary code or they may be even found in a contractual form as, for example, in licences or association membership agreements. They may have criminal or civil sanctions attaching to them, or give rise to disciplinary action.

Compared to the first three dimensions of legal rules, the fourth one – namely, the linguistic structure of rules - deserves more detailed examination because it explains the crucial role of interpretive communities in securing the effective use of rules. Black posits that in terms of linguistic structure rules have “three aspects: precision or vagueness, simplicity or complexity and clarity or opacity”.

The characterisation of a rule as precise or vague depends on the degree to which the operative facts of the rule are specified. There are a number of ways in which a rule may be vague: To quote from the relevant passage: “There could be a lack of specification as to the manner in which an action is to be performed (‘inform’, ‘publish’), or as to time or place (‘promptly’, within the vicinity) … the meaning of the word

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45 Above note 6, 21-24.
46 J. Black above note 6, 22; and W. Twining and D. Miers, above note 22, 205-216.
itself could be vague in that it is evaluative (‘reasonable’, ‘fair’, ‘suitable’)
… or … it could be vague in that it uses generic terms (…‘financial
instruments’ as opposed to ‘securities’).47 The simplicity or complexity of a
rule’s structure refers to the factual situations or assessments involved in a
determination of the rule’s applicability. A simple rule is, for example, the
following: “no licences may be granted to firms with less than twenty five
employees”. A complex rule is, for example, the following: “licences may
be granted to firms which comply with the following conditions…”48
Finally, the clarity or opacity of a rule refers to “the extent to which the rule
is understood by those applying the rule, be they following or enforcing the
rule.”49 Julia Black contends that clarity is a subjective assessment in the
sense that it depends on the interpretation, which the rule receives in a
particular community.50 Consequently, the meaning of a vague rule may in
fact be crystal clear in a particular community, although it may be opaque to
those outside it.

The analysis of rules in light of their dimensions opens up the possibility of
formulating rules in a more sophisticated manner. It is no longer necessary
to treat the issue of rule formation as a matter of striking the appropriate
balance between rules and standards and stipulating the level of discretion
accordingly.51 Instead –Black argues- we can think of the dimensions of
rules as representing different decision points and model out rules on this
basis.52 It also makes possible the application of rule-type to address issues
as diverse as the problem of over- and under- inclusiveness, the distribution
of decisional jurisdiction and the choice of interpretative strategy.53 For

47 Above note 6, 22-23.
48 Above at 23.
49 Above.
50 Above at 24.
52 Above note 6, 24.
53 Above at 25-27.
example, the problem of under-inclusiveness, which becomes particularly acute when emphasis is placed on rules drafted in high level of precision, can be ameliorated either by making the rule purely recommendatory or by providing that sanction in case of breach will be discretionary.

It was noted earlier that the effective application of rules depends on their interpretation. Consequently, it is important for the rule-maker to know how the rule will be interpreted and whether the terms he uses will be clear to the regulated population, so that the rule will convey as much certainty as it is so demanded. Moreover, he needs to know the extent to which the rule’s addressees can be relied upon to ‘read in’ the tacit assumptions on which the rule is based.

This is essentially a problem of informational asymmetry. The typical way to deal with it has been to regulate the ensuing relationship of economic agency between the regulator and the regulated through the formation of precise, prescriptive and complex rules that is, rules tailor-made to leave hardly any scope of discretion to the regulatees as to the proper meaning and application of rules. However, as it was explained a few paragraphs above, relying too much on prescriptive and detailed rules comes at the cost of under-inclusiveness. Therefore, Julia Black argues that a better way to deal with this problem is to encourage and sustain a shared and informed understanding of the rules and the practices they regulate. Indeed, the greater the shared understanding of the aim of the rule and the context in

54 Above at 12-13 and note 16.
55 Above 33.
56 Above.
58 Above note 6, 20.
60 Above note 6, 30-31.
which it operates, the less the need for explicitness and, consequently, the less the need to draft rules in high level of precision, for the rule-maker can be confident that the way in which he understands a particular regulatory norm and the way in which the regulated population understands it converge. Accordingly, there will be more scope to put in place a greater variety of rules to reduce instances of over- and under-inclusiveness — including rules containing vague terms.

The development of regulatory interpretive communities is the key to fostering the requisite shared and informed understanding. These constitute "institutional practices, which may exist in the form of shared cultures, norms, goals, definitions, and can be created through … training and education". Julia Black offers an account of regulatory interpretive communities drawing heavily on the earlier work of Stanley Fish on interpretive communities. Fish sees the interpreter and reader of the (legal) text as a member of a community whose institutions shape his perception of the world. He declares that those who belong to the same interpretive community can judge the correctness of an interpretation by applying the community’s shared standards and values. The latter are not static. They change as the interpretive community changes.

The creation of regulatory interpretive communities has significant implications for the design of the institutional structure of the regulatory

61 Above note 6 at 31 and note 17.
62 Above note 6 at 31-32.
system. Apart from the implications concerning the accountability of regulators, which could be addressed by ensuring that those affected by the regulation are involved in the formation of the rules, a crucial precondition for their development is the ‘closing-off’ of the regulatory system from external interference so that the interpretation ultimately accepted as ‘correct’ by the adjudicator is in accord with that of the regulator’s. Significantly, this requires conferring the monopoly of the formation and application of rules to a regulatory body and/or giving precedence to the regulator’s interpretation.

Nevertheless, it must be stressed, that even if the system is closed-off so that the rule maker can rely on the adjudicator to confirm his interpretation of the rule, relying solely on adjudication is not recommendable not least because adjudication is linked with reactive means of enforcement, namely regulatory tools that may not always be appropriate due to their drastic nature and the high cost associated with their application. Consequently, the aim in fostering interpretive communities should be to create conditions which will ensure that rules receive mutual interpretation by all those involved in the regulatory process: rule-maker, enforcer, and the regulatees.

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64 Above note 6, 37.

65 There are at least three potential interpretive actors in the regulatory system: the regulator, the court and the regulated population. Each has to share the other’s interpretive approach and each needs to be aware of that of others. Frequently their interpretive approaches are in conflict. This is particularly intense between the regulator and the court. A device to minimise this conflict (favoured in Rules and Regulators), is to bring together the regulator and the regulatees and exclude the court from the interpretation of rules. Above at 34-35; and J. Black, ‘Using Rules Effectively’ in C. McGradden (eds), Regulation and Deregulation (1999), 95 at 101-104.

66 This means that the court will be bound to strike down the regulator’s interpretation only if it was not within the range of interpretations that could be reasonably expected of the rule. This interpretive approach has been suggested in R v Panel on Takeovers and Mergers, ex p. Datafin [1987] 1 All ER, 564 and by Professor Paul Craig, Administrative Law (2005), 375-378.


To this effect it is necessary to adopt an educative as well as a command and control approach.\(^69\)

According, to Black, interpretive communities may provide solutions to a wide range of problems especially that of uncertainty and the selection of interpretive strategy.\(^70\) For example, uncertainty can be tackled through the promotion of “instinctive compliance” with the rules. Similarly, the need for explicitness may be reduced where members of the regulatory community share a common understanding of their purpose and context in which they operate. Furthermore, it is thought that once the regulatory system is sealed from external interference, the regulator becomes better able to deal with creative compliance because he is in better position to control and manipulate the interpretive strategy of the regulated population.

Conversational regulation encapsulates the idea of setting into operation a style of regulation that resembles that of conversation.\(^71\) Its main advantage is that it can afford the use of generalisations and vague terms because it has the capacity for qualification and clarification of the meaning of regulatory norms in a manner that is attentive to the idiosyncratic features of each particular case.\(^72\) Perhaps the most distinguished feature of conversational regulation is the emphasis on the individualised application of rules.\(^73\) The routinely adjustment of regulatory norms is made possible through the


\(^{70}\) Above note 6, 32-36.

\(^{71}\) Above 37-44.

\(^{72}\) Where a conversational style of regulation is adopted, rules and enforcement are found in a relationship of ‘reflexive equilibrium’. This means that rules may affect the enforcement strategy but the enforcement strategy may also influence the type of rule that may be adopted. Above note 6, at 38 and 41 respectively.

\(^{73}\) This may be put into practice either by enforced self-regulation in which individual firms formulate their own rules under the supervision of a regulatory body or through a procedure where the regulator negotiates with a firm the application of a rule. On the concept of enforced self-regulation, which is essentially a method of rule-formation rather than application of existing rules, see I. Ayres and J. Braithwaite, above note 69, 101-106.
deployment of a plethora of formal and informal means. For instance, waivers and exceptions facilitate the application of rules on individual basis by substituting informal procedures of rule-adaptation especially where these are not deemed to be time and cost efficient. The advantages of adopting a conversational style of regulation are obvious especially with regard to the problems of inclusiveness and those of lack of foresight. For example, the availability of waivers ensures that an over-inclusive rule will not apply where it was not intended to. By the same token, negotiations may extend the application of an under-inclusive rule in case of new and unforeseen circumstances.

A number of difficulties are ingrained in the choice of rule-type, the function of interpretative communities and the adoption of a conversational style of regulation. These can be classified into the following overlapping categories: (a) institutional constraints such as the prevailing bureaucratic ethos, the size of the regulated population, informational asymmetries within the regulatory organisation and scarcity of resources; (b) economic agency triggering conditions of rent-seeking and regulatory capture; (c) the often conflicting nature of the objectives of the regulatory policy of rule-use and last but not least; (d) problems of accountability.

In relation to the use of different types of rules, Julia Black identifies two kinds of problems. The first one is the inevitable tensions in the choice of rule-type. These are the outcome of the often-conflicting objectives that the regulator needs to accommodate when shaping the policy of rule use. For instance, certainty clashes with flexibility in that the former calls for precision and control of interpretive discretion while the latter points to the

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74 Above note 6, 39-40.
76 Above note 6, 38-41.
77 Above at 28-30.
quite opposite direction requiring vagueness and reliance on the interpretive judgement of the regulated population. Similar to the need to pre-empt complexity is at odds with the goal to reduce instances of over-inclusiveness. Furthermore, the desirability to tackle creative compliance and complexity contrasts with the desirability to decentralise the enforcement of rules through a system of private enforcement given that the prosecutability of rules requires tipping the balance in favour of detail and precision. The second kind of problem is that some times rules fall short from controlling the behaviour of bureaucratic officials. In this regard, it has been pointed out that the automatic association of interpretive strategy or relative amounts of discretion with a particular rule-type may not control bureaucratic discretion but simply displace it.

With respect to the first problem Black argues that the tensions in the choice of rule-type can be mitigated through trading-off the conflicting objectives against one another and compromising their accomplishment. For instance, the tension between certainty and flexibility can be reduced if a mixture of different types of rules is used to provide both the desirable adaptability and assurance. She also contends that regulators would be in a position to control literalism by allowing for some degree of interpretive discretion to the regulatees and ensure at the same time that the discretion granted is appropriately used, if the technique of rule-type was used in

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78 Above note 6, 28-29.
79 Above.
80 This is because some types of rules are not appropriate for all enforcement systems and strategies. For example, studies on the economics of private enforcement suggest this operates efficiently where it is put in practice through precise and detailed rules. By contrast, where a compliance strategy of enforcement is adopted involving negotiation, advice, education and compromise with the regulatees, then less precise rules can aid the enforcement process. R. Landes and R. A. Posner, ‘The Private Enforcement of Law’, Journal of Legal Studies (1975), 1 and; R. Baldwin, ‘Why Rules Don’t Work’, 51 Modern Law Review (1991), 321 and Rules and Government (1995), 143-57.
81 Above note 6, 28.
82 Above note 6, 28; and R. Baldwin and K. Hawkins, note 7, 570.
83 Above note 6, 29.
conjunction with the development of interpretive communities. However, the second kind of problem - that of controlling bureaucratic behaviour through the use of certain types of rules - can be resolved only by changing the bureaucratic ethos through constant training and education of the members of staff.

The resort to interpretive communities is no less controversial. Interpretive communities require the closure of the regulatory system from external interference. This however is bound to create conditions where regulatory accountability can be easily undermined. In this connection, Black suggests that accountability can be eventually restored by ensuring that all those “affected by regulation are involved in the formation of the rules” and by allowing regulatory decisions and actions to be open to judicial review provided that courts will tend to give precedence to the regulator’s interpretations of its rules “striking them down only if they are not within the range of interpretations that could be reasonably expected”.

Finally, the adoption of a conversational style of regulation presents its own challenges. As with the function of interpretive communities, one source of concern is that conversational patterns of regulation may jeopardise regulatory accountability. This eventuality is particularly acute where the number of the regulated firms is large. In these circumstances the relative standing of those conducting the conversation becomes blurred and it may not be possible to consult with everyone that is likely to be affected by regulation.

84 Above note 6 at 29-30.
85 Closing-off the regulatory systems entails that the regulatory Authority has the monopoly of formulating and applying rules and, as a result, the exclusivity in deciding matters of interpretation.
86 Above note 6, 36-37.
89 Above note 6, 43-44.
90 Above at 42-43.
91 Above.
A further problem is that fairness may not be observed given that it is
difficult to secure consistent decision-making. Finally there are difficulties
with the operation of waivers per se. In theory, the waivers are desirable
because they allow regulatory responses to be targeted. However, if a rule is
more often waived rather than applied, the use of waivers becomes
problematic because they turn out to operate like a device that negates
rather then reinforces the regulatory norm that constitutes the essence of
the rule itself.92

These difficulties can be ameliorated in a number of ways. For instance,
record-keeping and the availability of regular post hoc review of waivers can
help preserve consistency,93 whereas accountability can be secured by
making decision-making open and transparent. It must be pointed out,
however, that systems designed to increase participation and openness
operate more easily at the stage of rule formation rather than the stages of
rule application and enforcement. Nevertheless, it is submitted that this
problem can be addressed, for -unlike the stage of rule formation- the
application and enforcement process need not involve the participation of a
wide range of interests.94 Suffice is, that the consideration of wider interests
is secured at the stage of rulemaking.

3. The communicative theory of regulatory interpretation

3.1 A first look at the underlying assumptions of Black’s thesis: The
idea of interpretive convergence

92 Above note 6 at 44. In this manner the application of rule offers an occasion of negotiation, which
eventually erodes the capacity of rule in bringing about the intended policy objective.
93 Above 42-43.
94 Above 44.
Black builds her thesis on a pragmatic depiction of the interpretive process that makes possible the use of rules in financial regulation. Under this account, regulatory interpretation is a form of communication—a conversation that is full of shortcomings.\textsuperscript{95} Specifically, the analysis is particularly attentive to the conspicuous fragmentation that dominates the financial markets landscape. Being itself the outcome of increased specialisation and diversity of products and services and taking the form of sectoral and sub-sectoral market divisions, whose participants develop their own shared cultures, norms, goals, definitions and interpretive attitudes,\textsuperscript{96} market fragmentation brings about two important consequences. On the one hand, it gives rise to the flourishing of a variety of idiosyncratic understandings of regulatory requirements (interpretive discrepancy) and, on the other hand, it makes communication between the regulator and the regulated population remote and difficult to conduct effectively.\textsuperscript{97} Moreover, in the absence of arrangements designed to strengthen networks of communication, interpretive discrepancy becomes greater and greater not for market fragmentation preserves conditions that discourage the creation of a common ground of communication, influence and persuasion.

With this setting as a background, interpreters are depicted as they actually are namely, as individuals who do not posit any universal truth about how rules should be understood. As it was just pointed out, the regulatees are taken to develop their own understandings of regulatory prescriptions. Furthermore, they are described as generally unable to know whether their interpretation of rules is in agreement with that of the regulatory Authority—something, which leaves them exposed to an increased risk of litigation as

\textsuperscript{95} Various passages in \textit{Rules and Regulators} regarding the adoption of a conversational style of regulation testify that regulatory interpretation is seen as a dialectical practice pretty similar to ordinary conversation. Above note 6 at 37-44.


well as other costs. Similarly, regulatory officials are not deemed to possess perfect knowledge when exercising their rulemaking, supervisory or enforcement functions. Rather, they are taken to be aware of their own limitations. For example, they are cognisant of how essential practitioner’s input is in making informed choices and consequently how crucial it is to gain the trust and cooperation of the regulated population.

All these observations make plain that information asymmetries and interpretive discrepancy are the root of the evil, the source where all deficiencies in the use of rules come from. Compared to informational asymmetries, interpretive discrepancy is a far more pervasive problem when it comes to the effective use of rules. This is because it is conceivable to suppose that interpreters posit perfect information and still lack the requisite “tacit understanding” of regulatory norms, which is the catalyst for automatic adherence with regulatory stipulations. With this in mind it is safe to conclude that if rules are to work at all in the regulatory context, then interpretation should primarily aim at promoting some sort of interpretive convergence that is, a state of affairs where the regulatees’ understanding of regulatory norms and the regulator’s understanding of them coincide or -to put it differently- where there is a consensus about the ad hoc interpretation of regulatory prescriptions without the need of further clarification and guidance.

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98 By contrast, it is not intelligible to assume that interpreters have reached a state of affairs where they have developed a tacit understanding and at the same time argue that information asymmetries jeopardise effective communication. The idea of unreflective rule following is discussed in J. Black, note 6, 16-19.

99 With respect to the interaction between the interpretation of rules and social context, Black demonstrates how “agreement” in judgements is a function of shared understandings (or “forms of life” as Wittgenstein puts it) and uses the term “mutuality of interpretation” instead of interpretive convergence used here. Above note 6, 16 and 30-37. Stanley Fish in his turn talks about “agreement.” As he explains, once an interpretive community is fully fleshed its members “will necessarily agree because they will see … everything in relation to the community’s assumed purposes and goals.” S. Fish, Is There A Text in the Class?, above note 11, 15.
Black proposes some interesting ways in which interpretive convergence can be attained without harming market competition and innovation. One of the first things that she recommends is the combined use of various types of rules with an emphasis on high-level principles.\(^{100}\) There is a good reason why high-level principles should be preferred in this occasion. Rules drafted in a high-level of generality usually take the form of brief authoritative statements, which have mainly two advantages. They communicate clearly what objectives must be pursued and they leave for the regulated population to decide what is the best means to achieve these objectives. In this manner, high-level principles aid the regulator in his task to guide the regulated firms on how regulatory requirements should be understood and, at the same time, they de-centralise the interpretive process so that decision-making as to the appropriate mode of action is transferred down to each individual firm and business where it is needed most.

Firms are not left alone in exercising their interpretive discretion. A number of initiatives are proposed in support of the function of high-level principles.\(^{101}\) Under the proposed scheme in Rules and Regulators, a range of rules drafted in various levels of concreteness and specificity are used in order to explicate the content of high-level principles as well as to regulate their prosecutability,\(^{102}\) whereas certainty is reinforced by the creation of interpretive communities and the adoption of a communicative style of regulation.\(^{103}\) Indeed these techniques ameliorate informational asymmetries in various ways as, for example, by (a) cultivating a shared understanding of the rules; (b) aiding the regulator’s attempt to make an informed interpretation of regulatory norms and; (c) by ensuring that -in case of

\(^{100}\) Above note 6, 22-27.
\(^{101}\) Above at 31-33 and 37-44.
\(^{102}\) These rules prescribe acceptable and non-acceptable behaviour either by way of legally binding regulatory requirements or by way of guidance. Above at 24-30.
\(^{103}\) Clarity is not a function of the rule per se. Above at 18.
doubt- firms become duly informed about the regulator’s understanding a particular regulatory requirement.

Finally, Julia Black addresses a third challenge, namely the need to coordinate the decentralised interpretive process in order to ensure consistency in the interpretation of rules and differentiation only where it is considered absolutely necessary. To some extent interpretive discretion is controlled through the use of legally binding detailed rules. However, detailed rules cannot create a shared understanding of the regulatory norms on their own. Instead, interpretive communities do and they are extensively relied upon to create the necessary conditions for co-ordination.

This is a raw and rather untidy description of the theoretical account of regulatory interpretation that ensues from Rules and Regulators. I suggested that an emerging theme in Black’s thesis is the idea of interpretive convergence as an essential precondition for using rules effectively. Standing on its own, this claim sets the tone for a very interesting theory of regulatory interpretation where procedural efficiency is regarded the measure of effectiveness and the common denominator when trading-off conflicting policy objectives. Having said that, I am still far from offering a concrete account of the communicative thesis of regulatory interpretation. Clearly this project goes far beyond exploring the purpose of interpretation in regulation (interpretive convergence). It further requires discerning the subject matter of regulatory interpretation and defining the source of interpretive authority. These issues are discussed below.

3.2. Towards a more accurate picture of the communicative theory of regulatory interpretation

104 Above, note 6 at 28-29.
105 Above at 31-32.
Julia Black seems to argue that rules work effectively when there is some sort of interpretive convergence that is, when the regulated population interprets the regulatory requirements in a manner that is in agreement with the regulator’s interpretation.\textsuperscript{106} We notice, for example, that her recommendations about the level of specificity in which rules should be drafted is a function of how much it is considered essential to control interpretive discretion. Similarly, the policy choice of using rules that are drafted in high level of abstractness and generality -namely the policy choice to rely on the interpretive discretion of the regulated population- is always coupled with parallel policy initiatives such as interpretive communities and a communicative approach to regulation whose purpose is to help the regulator guide, coordinate, manipulate and monitor the interpretive decision-making of regulatees. What theory of regulatory interpretation ensues from these observations? Drawing on Ronald Dworkin and his analysis of interpreting a social practice like rule following, we can argue that a theory of regulatory interpretation can be either communicative either constructive in nature.\textsuperscript{107}

The distinct characteristic of the communicative theory of interpretation is that it resembles the method of interpretation that we deploy when we try to understand our co-discussant in the course of a conversation. In this case we allot meaning to the speaker’s utterances in light of his motives or concerns and we report our conclusions as statements about his intentions in saying what he did. So to put it simply, we try to grasp the speaker’s

\textsuperscript{106} S. Fish, \textit{Is There a Text in the Class?}, above note 11 at 15 and note 6, 24-44.

\textsuperscript{107} To be precise, Ronald Dworkin propounds three different kinds of interpretation; “conversational”, “constructive”, and “scientific interpretation.” “Scientific interpretation” does not qualify as a candidate theory of regulatory interpretation because it is causal rather than purposive in nature. Here the term “communicative is used in place of “conversational” as more appropriate for capturing the idea that in the public domain taking part in a conversation always serves some purpose (e.g. the provision of clarification, the resolution of disputes, the promotion of social order or cooperation etc). R. Dworkin, \textit{Law’s Empire} (2000), 49-53.
intention in speaking as he does. Under this theoretical model, interpretation is a means for communicating each other's rationalities. Interpreters are not concerned with finding out what the rule “really” requires from them to do, but what their co-discussant think that the rule in question requires from them to do. Their modest ambition is to ensure effective communication. Significantly, the latter commands overcoming information asymmetries and ideally the attainment of a common understanding of the regulatory norms. With these down-to-earth concerns in mind, interpreters treat interpretation as a medium for becoming aware of each other’s rationalities and point of views and, as a vehicle of persuasion and consolidation of conflicting interpretations. 108

Contrary to the communicative theoretical model, the constructive theory of interpretation is more ambitious in its inception. 109 It draws a sharp distinction between the speakers’ utterances and the object of interpretation to the effect of proposing that, discerning the speakers’ beliefs about the object of interpretation and discerning the object of interpretation per se, are two different projects. Under this theoretical model, interpreters are seeing as genuinely interested in making the best sense of the object of interpretation—the object being the rule as embodied in the legal text. To this effect, they ascribe some scheme of interests or goals or principles that the subject matter of interpretation can be taken to serve, express or exemplify, rather


109 The constructive theory of interpretation is grounded on the assumption that the participants in a social practice like law or more generally rule-following approach their subject of interpretation with an interpretive attitude. Dworkin describes the notion of interpretive attitude by using the analogy of “courtesy”, a social practice of rule following, which after some point of time starts to change. Above note 107, 46-49. I discuss this point in the subsequent chapters.
than simply understand each other’s utterances.\textsuperscript{110} It follows that under this theoretical scheme, what a rule means and what the interpreters take it to mean are not tautologous. Finally, contrary to the communicative theory, the constructive theory does not regard the presence of disagreement as a pathological feature, but as a manifestation of sound argumentative practice, which is tailor-made to meet the need for new and better interpretations of the rules in question.

It is suggested that the theory of regulatory interpretation that emanates from \textit{Rules and Regulators} is communicative in nature. It was pointed out already that the presence of an on-going dialogue between the regulator and the regulated population is implied in the discussion of the adoption of a conversational style of regulation. However, to get a deeper insight into the subject matter, purpose of regulatory interpretation and the source of authority, it pays to keep in mind the earlier remarks on the idea of \textit{interpretive convergence} and turn our attention to the function of the regulatory interpretive community, not least because it is its members that conduct this conversation.\textsuperscript{111} In the remaining of this section, I examine the rationale and operation of the regulatory interpretive community in order to support my suggestion. Progressively, the discussion will pave the way to a more concrete account of the assumptions underlying the theory of regulatory interpretation that is embedded in Black’s work.

That a regulatory interpretive community is created out of a concern to address informational asymmetries and promote stability and co-ordination - namely the same difficulties that the communicative theory supposes as

\textsuperscript{110} In the case of Dworkin’s analysis the subject matter of interpretation (‘the object’) is a social practice – specifically the practice of rule following. In the case of financial regulation the subject of interpretation is the various regulatory provisions as, for instance, COB rules.

\textsuperscript{111} Above the discussion on interpretive communities (pages 167-169) and the idea of interpretive convergence (note 99 at page 176).
impeding effective communication, becomes clear once we pay attention to a very conspicuous feature of the practice of rule-use in the regulatory context, namely the mounting uncertainty about the interpretation of ambiguous regulatory norms.\textsuperscript{112} If everyone involved in the regulatory system had perfect information about how others would behave and what strategy they would adopt in interpreting regulatory requirements, if everyone agreed on how rules are to be understood, things would be ideal, and there would be no need for the creation of an interpretive community. Since things are far from ideal in reality, the formation of an interpretive community is essential in order to reduce information asymmetries and cultivate a shared understanding of the regulatory requirements.

This insight is embedded in several remarks contained in *Rules and Regulators* with respect to the difficulties that a rule maker encounters as a result of the contingency of the application of rules to their interpretation. For example, Julia Black points out that “[b]ecause of the need to rely on others to apply and interpret the rule the rule maker needs to know how the rule will be interpreted: [...] The rule maker also has to know whether the terms that he or she uses will be clear to those interpreting the rules, and so whether the rule will give the certainty that is so demanded. [...] Finally the rule maker has to know the extent to which the rule’s addressees can be relied upon to ‘read in’ the tacit assumptions on which the rule is based.”\textsuperscript{113} Yet, the rule-maker is not the only one who feels strained under conditions of imperfect information and interpretive divergence giving rise to disputes about ambiguous rules. The regulated firms experience similar distress, not least because they face an increased litigation risk, in the absence of any

\textsuperscript{112} In *Rules and Regulators*, the term “regulatory interpretive communities” connotes the presence of associations of rule makers, regulatees and virtually every one involved in the regulatory system, with the view to create a shared culture, set of norms, goals, definitions and common interpretative strategies. Above note 6, 31-32 and note 17.

\textsuperscript{113} Above.
reassurance that their interpretation of regulatory requirements coincides with the one preferred by regulatory officials.\textsuperscript{114}

Taking into account that the regulator and the regulatees\textsuperscript{115} confront similar problems, it is suggested that both have good reasons to be looking forward to part taking in the interpretive community. Seeing things from the angle of the regulatory Authority, interpretive communities are to be welcomed because (a) they can help them make an informed interpretation of rules; (b) communicate how they expect others to interpret rules more effectively and (c) ensure optimal compliance by reassuring the regulated population and cultivating a sense of legitimacy. Seeing things from the angle of the regulated firms, interpretive communities are to be welcomed because (a) they can help them make an informed interpretation of rules (informed in the sense of knowing that it will accord with the regulator’s interpretation); (b) they give them reassurance by promoting certainty and predictability; and (c) they foster their confidence in the fairness of regulation.

That the notion of regulatory interpretive community in \textit{Rules and Regulators} is based on the assumptions, that the communicative thesis makes in relation to the subject matter and point or purpose of interpretation, becomes plain, once we consider what the interpreters do, as soon as a primitive form of interpretive community starts to take shape. Suppose that a regulatory interpretive community as of the kind described in \textit{Rules and Regulators} is at an early stage of evolution and that it consists of the following three members: the regulator, who also happens to be the maker and

\textsuperscript{114} “In the demand for certainty what is being sought is the assurance that my interpretation of the rule will accord with others’, in particular the person or institution that ultimately has the responsibility for determining the application of the rule.” Above note 6, 32.

\textsuperscript{115} Their role in the regulatory system always remains distinct. FSA plays the role of the policy maker, rule maker and enforcer, whilst the regulated firms stand at the other end as the recipients of regulatory commands and recommendations and as the regulator’s consultants.
enforcer of rules, the regulated firms and consumers.\textsuperscript{116} Suppose also that the regulator considers amending a particular regulatory provision – say, for the sake of argument, Conduct of Business rule (z)-, which establishes a favourable regime for consumers of personal pensions (‘packaged product’).\textsuperscript{117} Specifically, COB (z) requires financial advisers who sell a particular range of products and services\textsuperscript{118} to look outside their range of product and services before they recommend a personal pension to consumers, and explain in writing why the particular personal pension contract they have recommended is at least suitable for their customers as a form of stakeholder pension. With the view of bringing the selling of personal pensions in line with the selling of other packaged products, the regulator wishes to replace COB (z) with COB (z’) so that in the future “tied financial advisers” will not have this obligation unless their customer explicitly requires from them to do so.\textsuperscript{119}

The membership in the regulatory community (strictly speaking, a regulatory interpretive community is not yet fully fledged) instigates a communication process, which enables the regulator to assess whether the regulated firms and those that are likely to be affected by the proposed change are generally

\textsuperscript{116} I assume that the court is excluded from participation to make the constitution of regulatory interpretive community resemble to Black’s account as much as possible.

\textsuperscript{117} The hypothesis draws heavily from COB 5.3.16 (3) (also known as RU64), which raised great controversy during the past two years. FSA expressed the view that COB 5.3.16 (3) was obsolete and considered removing it so that to bring the standards governing the selling of personal pensions into line with those of all other packaged products. This proposal was supported by the industry but found strong opposition from consumers. The Authority eventually decided to postpone its revision for the future. FSA ‘Suitability Standards for Advice on Personal Pensions’, FSA Consultation Paper CP05/8 (June 2005); FSA, ‘Suitability Standards for Advice on Personal Pensions: Feedback on CP05/8’ (February 2005), FSA Feedback Statement; D. Waters ‘FSA Move to Free Up Advice on Personal Pensions’, FSA Press Release (28 June, 2005). According to the FSA Glossary, a “packaged product” is (a) a life policy; (b) a unit in a regulated collective investment scheme; (c) an interest in a collective trust savings scheme and (d) a personal pension scheme [available at www.fsahandbook.info/FSA/html/handbook/Glossary/P]

\textsuperscript{118} These financial advisers are known as “tied advisers” as opposed to “wholesale advisers” (they compare the whole range of products and services that is available in the market before offering advice). Effectively, COB (z) asks from “tied advisers” to exceptionally act as “wholesale advisers” when they recommend personal pension contracts to their consumers.

\textsuperscript{119} This means that in my fictitious example the regulator takes advantage of the operation of interpretive communities in order to perform his rule-making function. It is conceivable, however, that interpretive communities in varying degrees of participation aid the regulator’s more general attempt to adopt a conversational style of regulation.
in agreement with his proposals and, in addition, it provides a forum for persuasion in case of disagreement. This is not a monologue, however. Both the regulated firms and consumers seize this opportunity to make the regulator aware of their views to the effect of influencing regulatory rule making in their favour.\textsuperscript{120} Despite their conflicting interests, the members of regulatory interpretive communities develop an interpretive attitude that has some fundamentally common characteristics. They communicate with each other first because they wish to become aware of the extent to which their views differ (interpretive divergence), second, because communication gives an excellent opportunity to share information and third, because it is through this exchange of information that they can hope to cultivate a common understanding of COB (z).

Discovering each other’s intentions stands at the core of this common pattern of interpretation, exactly as one would expect in a description of regulatory interpretation that follows the communicative thesis. Indeed, unless I know my co-discussant’s intentions I cannot make sense of his claims and, as a consequence, I cannot assess where our interpretations differ with the view of working out a strategy to bridge our differences and attain an agreeable interpretation. There is no point to treat the rule itself as an entity distinct from the discussant’s utterances because all I can make sense of -and all effective communication requires from me to make sense of- is my co-discussant’s sayings about the meaning of the rule in question.

One might object that it is not accurate to say that the subject matter of interpretation is the interpreters’ intentions. In light of the positivist

\textsuperscript{120} The Public Choice school of thought and the doctrine of regulatory rent-seeking offers an excellent law and economics explanation of how different interest-groups compete to take regulatory decision making by their side. In this battle, the economically powerful group wins; its rationality dominates the regulatory arena and sets the tone for the subsequent interpretation of regulatory commands. D. C. Mueller, \textit{Public Choice III} (2003), chapters 15 and 20.
foundations of *Rules and Regulators* is seems natural for one to suppose that only the intention of the person who authored the rule in question matters (in this particular case, the regulator). This objection does not apply where a regulatory interpretive community is fully fledged because the reign of a mature interpretive community implies the presence of absolute convergence between the author’s intention and the interpreters’ intention. It applies, however, in numerous other occasions where it is conceivable to assume that the regulator and the regulatees do not share the same interpretive intention and, therefore, it is worthy of attention.

When I argue that the subject matter of interpretation is the interpreters’ intentions I do not mean to suggest that the author’s intention is excluded from consideration. Frequently, it will be a situation where interpreters will have to discern the author’s intention. But this will be so only because the ‘author’ happens to be one of the co-discussants and members of the community of interpreters and particularly the one, who is delegated with the power to command adherence with COB rules, and with whom the other members of the regulatory community try to communicate effectively. After all we should not lose sight of the fact that regulatory interpretation is a constant dialogue between the regulator (and author of the rules) and the regulated population in the course of which the regulator is supposed to do more than simply author rules, monitor compliance and enforce them. He is expected in addition to sense interpretive discrepancies, revise the content of regulatory requirements in light of practitioner input and overall negotiate their application and enforcement. To cut a long argument short, it is the

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121 Despite appearances to the contrary, the question as to who is the ‘author’ of a rule—especially when the latter takes the form of a regulatory requirement—is not at all straightforward. The notion of ‘intention’ is equally troublesome. For the purposes of this section I work on the assumption that the ‘author’ is the regulator and that the concept of ‘intention’ raises no problems. I will return to these points in the next chapter.

122 Stanley Fish does not hesitate to talk about “uniformity” among the members of the interpretive community. S. Fish, *Is There a Text in This Class?*, above note 11, at 15; and O. Fiss, ‘Conventionalism’, note 16, at 177.
reciprocity of this dialectical practice that -in my view- lends support to the claim that the discovery of the intention of each regulated individual matters at least as much as the discovery of the author’s (the regulator’s) intention and this without turning a blind eye to the ex officio privileged position of the regulator as the sole member of the interpretive community who is entrusted with the power to resort to coercion in pursuit of its regulatory mandate.

The centrality of the interpreters’ intentions has two implications. The first one is that in the absence of a mature interpretive community, it brings about a wealth of different and frequently conflicting interpretations. The ensuing plurality of interpretations presents a huge challenge for the effective use of rules, because it breeds conditions of disagreement and uncertainty. At the end of the day only one interpretation will be accepted as the ‘correct’ one and, given the special function of the regulator, this seems to be the regulator’s preferred interpretation.123 Does that mean that the regulator decides questions of interpretation and then enforces them to the other members of the interpretive community? The answer is no. The regulatory regime envisaged in Rules and Regulators is far from a typical command and control regime. Regulatory officials do not stand outside the interpretive community when performing their tasks. They work within it in pursuance of a mutual interpretation of regulatory norms. Accordingly, the “regulator’s preferred interpretation” is the outcome of a dialogue that aims at agreement and reconciliation through persuasion.124 It is this consensus-based decision-making project that -not only filtrates the exercise of interpretive discretion and determines the margin of acceptability of the

123 Above note 6, 33.
124 The interpretive community gives voice to all those that are likely to be affected by regulation –not for the sake of preserving differentiation in the interpretation of regulatory requirements but- because providing a forum of communication is the first step to bridge differences and work out an agreeable interpretation. On persuasion see, Fish, Is There a Text in This Class, above, note 11, ch. 16.
proposed interpretation— but also manifests the point or purpose of the regulatory interpretive community. The second implication that derives from the centrality of the interpreters’ intention is that the authority in matters of interpretation lies with the interpretive community.\textsuperscript{125} As Stanley Fish claims and Julia Black endorses “it is interpretive communities, rather than either the text or its author, that produce meanings.”\textsuperscript{126}

Although many would feel at ease with my claim that in \textit{Rules and Regulators} the point or purpose of regulatory interpretation seems to be the attainment of some sort of agreeable interpretation (\textit{interpretive convergence}), the same does not apply with respect to my suggestion that the authority in matters of interpretation lies with the regulatory interpretive community. How is it possible—one might ask—to argue that the interpretive community is the arbiter of what is acceptable and non-acceptable interpretation in view of Professor Black’s attempt to disassociate herself with the radical interpretation school of thought?\textsuperscript{127} How is it possible to propound that rules mean whatever a community of interpreters wants them to mean, when in \textit{Rules and Regulators}, it is explicitly stated that the authoritative nature of legal rules trims down the range of available interpretations?\textsuperscript{128} This is even more so, taking into account that the creation of an interpretive community presupposes the closure of the regulatory system from judicial interference and, as a consequence, immunity from any external control over the regulatory interpretation.\textsuperscript{129}

\textsuperscript{125} Above note 23, 14.
\textsuperscript{126} Above.
\textsuperscript{127} Above note 21 at page 10.
\textsuperscript{128} Above note 7, 17 and 32.
\textsuperscript{129} Obviously the claim that members of the interpretive community will control each others exercise of interpretive discretion cannot apply here because the creation of an interpretive community presupposes uniform interpretation and lack of disagreement.
The difficulty to reconcile my claim with the spirit of *Rules and Regulators* is more apparent rather than real.\textsuperscript{130} Despite the disavowal of the radical school of thought and sporadic warnings that the authoritative nature of rules limits the remit of acceptable interpretations, the fact of the matter is that Julia Black clearly argues for the courts giving precedence to the regulator’s interpretation, striking it down only in exceptional circumstances.\textsuperscript{131} This alone leaves plenty of scope not only to construe that the regulatory interpretive community (recall, here that the regulator acts as a member within this community) is the only source of constraints over interpretive discretion but to corroborate, in addition, the positivist and conventionalist affiliations of *Rules and Regulators* by arguing for a notion of acceptability that is based on social convention.\textsuperscript{132}

To conclude, I argued that in *Rules and Regulators*, we find the first materials for a theory of regulatory interpretation that is communicative in nature. Its underling assumptions can be summarised in the following points: (a) Regulatory interpretation is a form of communication, which takes place in a fragmented social context where each one of the discussants has its own personal point of view about how regulatory requirements (legal rules) should be understood. (b) The meaning of rules depends on the interpreters’ varying intentions. This bears with it the following overlapping implications: First, regulatory requirements may be assigned to an indefinite number of valid meanings as many as the views expressed by the interpreters. Second, in the presence of this plurality of meanings, communication is prone to failure. It is expedient therefore to ensure that interpretive convergence

\textsuperscript{130} This issue is far more complex than it is suggested here. It demands a thorough analysis of the relationship between the judiciary and public administration, which falls beyond the scope of this thesis.

\textsuperscript{131} On that view, the courts are allowed to strike down the regulator’s interpretation provided that it does not fall with the range of interpretations that one would reasonably expect. This position was developed in *Datafin case. R v Panel on Takeovers and Mergers, ex p. Datafin* [1987], QB 815, especially 849-869, where Lloyd J argued that the availability of judicial review becomes much less controversial when the source of power is statutory (rather than contractual); Above note 6, 37; and P. Craig, note 66.

\textsuperscript{132} Stanley Fish argues that, “the meaning and texts produced by an interpretive community … proceed… from a public and conventional point of view.” S. Fish, *Is There a Text in This Class*, above note 11, 14.
(rather than the search for truth) becomes the ultimate objective of regulatory interpretation. Third, the meaning of legal rules is informed by the prevailing perceptions of the interpretive community that is, the regulator who has the entrenched authority to use them and the regulated population whose sympathy and cooperation is crucial to make things work. The presence of an interpretive community is the only source of constraints over interpretive discretion. (c) In light of these claims, the communicative theory of regulatory interpretation answers the questions we set in the introduction of this chapter as follows: The subject of regulatory interpretation is the interpreters’ utterances, its objective is the attainment of consensus (interpretive convergence) and the only source of authority and constraints over interpretive discretion is to be found in the community of interpreters.

3.3. The merits of the communicative theory of regulatory interpretation

The merits of the communicative theory of regulatory interpretation become easily apparent once we reflect on the essence of its constitutive postulates in a little more detail. For example, it is not difficult to see what is so compelling in the supposition that the interpreters’ intentions are central in determining the meaning of rules. Rules are man-made and common sense suggests that their meaning is not out there in the world to observe it. Therefore, it seems that the only reasonable thing to do is to interpret them in light of the purposes, intentions and motives of each of the persons that are involved in the production and subsequent use of rules by asking why did they mean by that exactly the same way as we do in the course of a conversation when we are trying to grasp the meaning of utterances of our co-discussants in light of the purposes, motives and aspirations we suppose for them to have.
This brings me to the second point I wish to make concerning the authority of regulatory interpretive communities in imposing constraints over the exercise of interpretive discretion and the consensual character of interpretation. I can think of at least two arguments in support of the view that the presence of interpretive communities is the only source of constraints to interpretive discretion.

The first one is once again common sense. Insofar as one subscribes to the idea that the meaning of rules is contingent to the interpreters’ intentions, one accepts that regulatory interpretive communities are the only logically conceivable source of control over interpretive discretion. Other candidate arguments would propound that boundaries are to be found in the legal text or that the interpreters’ beliefs about what a rule means are held in check by the authority of institutional principles. But is it not true that these claims commit us to a counter-intuitive world ontology? Is it not true that beliefs about the meaning of institutional principles and norms are no less subjective than beliefs about what a legal rule means? The meaning of a legal text does not stand out there waiting to be discovered. Similarly, institutional principles are nowhere really. Rather people use the language of principles to add to their subjective beliefs more persuasive power.133

The second argument in support of the authority of interpretive communities as envisaged by the communicative thesis lies in its ethical and moral constitution. It seems to me that the case for interpretive communities as the only source of control over interpretive discretion draws directly on the powerful idea that those likely to be affected by regulation are human beings and as such they should have the freedom and

133 Above note 16.
simultaneously the burden to decide matters of their interest for themselves.  

Therefore, regulatory officials and bureaucrats should not be allowed to push them around and indoctrinate them or decide in their stead.

What I said so far in relation to the authority of the regulatory interpretive community applies with equal force to the consensual character of regulatory interpretation that emanates from the communicative thesis. There are, however, additional reasons for one to be favourably predisposed to the view that regulatory interpretation is consensual in that those practising it are committed to the attainment of interpretive convergence. This becomes clear once we consider the conception of rule-effectiveness that ensues from *Rules and Regulators*.  

It is suggested that Black embraces a conception of rule-effectiveness that captures adequately well the down-to-earth concerns of the regulator and the regulatees; concerns, such as, being in a position to predict whether a particular mode of action will not trigger litigation risk, especially if we see things from the point of view of the regulated population or, how to cultivate the necessary psychological conditions for optimal compliance with the rules, if we see things from the point of view of the regulator. This conception of rule-effectiveness is consistent with one of our most basic intuitions about how financial regulation should go about, namely the intuition that financial regulation - and consequently the use of rules- should be procedurally efficient.

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135 My claim presupposes that there is something valuable in encouraging adherence with regulatory requirements upon reflection. This is not universally accepted however. Joseph Raz, for example, argues that law (and -I would add- regulation) must consist of directives capable of replacing the subject's judgment about how to behave. With other words, it must consist of commands that people ought to submit to without critical reflection. J. Raz, *The Authority of Law: Essays on Law and Morality* (1979), ch.1.

136 This topic is discussed in detail in Chapter Six.

137 As John Finnis puts it “One must not waste one’s opportunities by using inefficient methods. One’s actions should be judged by their effectiveness, by their fitness for their purpose, by their utility, their
means that in institutional terms financial regulation should be capable to address contingencies that hinder the efficiency of financial regulation as, for example, disagreements about the meaning of regulatory requirements, the lack of foreseeability as to the perpetually changing market landscape, the need to regulate the interpretive strategy of rules and the need to control the exercise of administrative discretion as to the interpretation of rules.

The consensual character of regulatory interpretation serves to bring this notion of rule-effectiveness into materialisation. It does so by setting a realistic agenda for the architects of financial regulation. Specifically, a policy of rule-use, that is informed by a communicative conception of regulatory interpretation, does not aim at discovering the objectively true meaning of regulatory norms; this would be naïve let alone dangerous, as it would bring the whole regulatory process into a deadlock. Rather, it encapsulates more modest and pragmatic objectives, as, for instance, the need to ensure that communication provides clarification, cultivates a common understanding of rules and fosters the necessary psychological conditions for optimal compliance. In addition to that, the idea that regulatory interpretation must be consensus-based brings with it a number of other advantages. These include strengthening regulatory accountability and gaining the trust of the public by opening up the regulatory system and cultivating a sense of fairness and legitimacy.

4. Conclusion

In Rules and Regulators, Julia Black develops a thesis for the nature and use of rules in financial regulation with the view of proposing ways in which we

consequences.” John Finnis, Natural Law and Natural Rights (2003), 111. See also T. Scanlon, What We Owe to Each Other (2000), at 79-80.
can make more effective use of them. Focusing on the linguistic nature of rules, Black identifies three limitations that diminish the regulator’s capacity to use rules effectively: over- or under- inclusiveness, indeterminacy and interpretation. She argues that these difficulties can be dealt with by deploying a mixture of different types of rules, the creation of a regulatory interpretive community and the adoption of a conversational style of regulation. This chapter offered an overview of her thesis with the aim of shedding light on a wealth of insights, which –when put together- comprise a very interesting account of regulatory interpretation. Starting from the observation that interpretive convergence is crucial for using rules effectively, the discussion progressively spelled out all those assumptions that lie beneath this idea and constitute what it has been called the communicative thesis.

According to the communicative reading, interpreting equals to communicating one’s personal beliefs about how regulatory requirements should be understood. It is an opportunity for sharing information and for reconciliation through persuasion. Significantly, the community of interpreters is seen as the only source of interpretive authority. What the rule in question means cannot stand independently of what the community of interpreters think it means, based on shared background of beliefs, intentions and expectations. Therefore, the subject matter of interpretation is not the rule itself but the interpreters’ utterances. Now, given the plethora of equally valid meanings that can be attached to a rule it becomes crucial that regulatory interpretation should work towards cultivating a shared understanding of regulatory requirements and ultimately towards interpretive convergence.
It is not difficult to see what is so compelling in the communicative theory of regulatory interpretation. On the one hand, it finds direct support to our common sense as well as to our fundamental intuitions about the moral constitution of the members of the regulatory community, which demands that they are not put aside when it comes to decide issues such as the production of new rules or the interpretation of existing ones. On the other hand, it offers an account of regulatory interpretation that is consistent with the idea that financial regulation -and consequently the use of rules- should be procedurally efficient. The communicative thesis is not free from problems. These are explored in the next chapter.
CHAPTER FIVE

Towards a Constructive Theory of Regulatory Interpretation

1. Introduction
This chapter considers some difficulties that are endogenous to the communicative thesis and progressively the discussion will pave the way to an alternative account of the nature of regulatory interpretation –the constructive thesis. So far, it has been argued that the communicative theory is based on the idea that the use of rules in financial regulation is a form of communication among members of a community of interpreters. Three suppositions constitute the nucleus of this claim. The first one is that the meaning of rules depends on the interpreters’ intentions and, therefore, the subject matter of interpretation is making sense of the discussant’s utterances; the second one is that the community of interpreters have the authority of signalling out what counts as acceptable or non-acceptable interpretation (the community of interpreters is the sole source of constraints over the exercise of interpretive discretion) and, finally, the third assumption is that the point or purpose of regulatory interpretation is to attain interpretive convergence.

These assumptions pose some very interesting questions. For example, with respect to the claim that the meaning of rules depends on the interpreters’ intentions, it comes naturally for one to ask: “How the notion of intention is to be understood?” “Do regulatory interpretive communities have intentions?” “If not, whose intention should we take into account in interpreting rules?” “Granted that interpreters often have more than one
intentions, how are we supposed to choose between them?” In relation to
the second postulate, “Is it appropriate to say that there is nothing to
constrain interpretive discretion – apart from the interpretive community
and the dominant ideology of the time?” “What about the text, in which
regulatory requirements are embodied?” “What about the fact that rules are
produced by virtue of a statutory mandate that the rule-maker is bound to
observe?” “Granted that the use of rules in regulation is part of our political
history, is this practice not a continuation of our political tradition to be
governed by the Rule of Law?” “Do all these not confine one’s available
options?” Similarly, the suggestion that regulatory interpretation aims at
interpretive convergence rather than ensuring that rules are correctly
interpreted raises its own questions:1 “Can interpreters agree on the
interpretation of rules and, still, get their interpretation wrong?” “In the
event of mistaken interpretation, can we still argue that rules are used
effectively?”

All these questions touch upon very contentious issues with respect to
interpretation. Therefore, it is suggested that before assessing the robustness
of the communicative theory of regulatory interpretation, we should first
improve our understanding of interpretation in general. Since regulatory
interpretation is a species of legal interpretation, I propose to do so by
comparing legal interpretation with interpretation in other fields of
knowledge, particularly literature.

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1 The idea of interpretive convergence was discussed in Chapter Four (note 99 at page 176 and page 177). No doubt, judges have the last word in deciding interpretive disputes. This, however, is not a licence for the regulator to do whatever he wants out of the rule in question. Insofar as he takes his office seriously, the regulator is bound to act within and not outside the premises of the Rule of Law. I will return to this point latter on.
The thought that law is like literature and that theory may profit by comparing the two is neither old nor counterintuitive. Both depend on the activity of interpreting text. In both domains authoritative interpretation becomes institutionalised. Not unlike literary text, legal text is interpreted as something that is distinct from its creator. Similarly to the interpreter of a classical canon, the judges (and virtually every public official who is entrusted with the interpretation of rules) have behind them a history of previous interpretations that filtrate and refine their grasp the legal text. Furthermore, legal philosophers and practitioners, struggle with the boundaries of linguistic sense as much as do critics of poetry and experimental literature.

Below, I temporarily put the discussion of regulatory interpretation aside to go back to basics. I explore the practice of interpretation in general drawing on the field of literature, with the view of getting a deeper understanding of those themes that are central to any theory that aims to offer an account of regulatory interpretation such as, the point or purpose of interpretation, the determinants of meaning, the presence (or absence) of limitations over interpretative discretion and authority. My next step will be to compare the practice of interpretation in literature with regulatory interpretation in order

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2 The Law and Literature Movement emerged in the USA around the late 70’s. R. Shiner, ‘Doing What Comes Naturally: Change, Rhetoric, and the Practice of Theory in Literary and Legal Studies by Stanley Fish’, 49(4) The Journal of Aesthetics and Art Criticism (1991), 375 at 375. This school of thought assumes that law is intrinsically linked with the philosophy of language. Not everyone shares this view, however. On that point see, M. S. Green, ‘Dworkin’s Fallacy, or What the Philosophy of Language Can’t Teach Us About Law’, 89 Virginia Law Review (2003), 1897.


4 Ronald Dworkin calls this kind of interpretation “creative interpretation” to distinguish it from other forms of interpretation namely interpretation in the course of conversation (“conversational”) and the interpretation of scientific data (“scientific interpretation”). R. Dworkin, Law’s Empire (2000), 50-51.

5 Regulatory officials are no exception to this rule, when asked to interpret their statutory mandate for the purposes of policy making, rulemaking and enforcement. These as well are the bearers of a wealth of past interpretations that shape their understanding of regulatory norms.
to highlight a plethora of features that share in common. Significantly, these features will reveal a picture of regulatory interpretation that is much different from the one under the communicative theory and, as a result- call into question the soundness of its underlying assumptions mentioned earlier. In light of this inconsistency, towards the end of this chapter, I will explore the possibility of developing an alternative theory of regulatory interpretation.

2. Interpretation in literature

2.1. The aesthetic hypothesis

The comparative examination of interpretation in literature and interpretation in law cannot be fruitful, unless we are prepared to see literary interpretation in a “certain light”. Ronald Dworkin explained what that light is by developing the aesthetic hypothesis.6

Starting from the observation that many things fall under the description of interpretation in literature, he argued that in order to get an insight into the practice of legal interpretation, our focus should be on those arguments, which offer some sort of interpretation of the meaning of a work of literature –say, a theatrical play- as a whole (interpretive arguments). A distinct characteristic of these arguments is that they have a practical point –for

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6 The discussion in this section draws heavily on R. Dworkin's comparative analysis of interpretation in the context of art and in the context of law. One of the core threads of his analysis is his criticism of the idea that the meaning of (legal) text depends on its author's intention. His arguments become of particular relevance in the case under examination because many insights are equally applicable in connection to the communicative thesis and, in particular, the claim that the meaning of rules is contingent to the interpreter's intention, the latter being reflection of the shared form of life of the interpretive community. Above note 4, chapter 2, particularly 49-86; R. Dworkin, Matter of Principle (2000), ch. 6 particularly 152-154, where he defends the aesthetic hypothesis against various objections; R. Dworkin, note 3, 527; and ‘My Reply to Stanley Fish (and Walter Benn Michaels): Please Don’t Talk about Objectivity Any More’ in W. J. T. Mitchell (ed), The Politics of Interpretation (1983), 287.
example, they inform a director about how to stage a new performance of a play—yet, they may also be of more general importance, as they may help us gain a valuable insight into our literary culture. *Interpretive arguments* take the form of statements about characters or events in the story behind the story or statements about the “point”, “theme” or “meaning” of the play as a whole. With respect to Shakespeare’s famous theatrical play *Hamlet*, examples of statements of the first kind are claims asserting that Hamlet loved his mother, or that Hamlet hated his mother, that Hamlet was schizophrenic or that Hamlet was simply a confused young man. Examples of the second kind include claims such as the assertion that Hamlet and Ophelia were lovers in the past or that Hamlet and Ophelia were completely strangers. Finally, examples of the third kind of statements constitute claims such as that *Hamlet* is a play about the relationship between sexes or that *Hamlet* is a play about political corruption.

Directors, critics, actors and members of audience alike disagree about how to answer questions that bear out *interpretive arguments*.⁷ According to Dworkin, these disagreements centre on the more fundamental question about which interpretation of *Hamlet* (or more generally any piece of literature) shows *Hamlet* the best work of art of its genre or—to put it differently— which way of reading or directing or acting reveals this play as the best work of theatrical art.⁸ In this regard, different theories of interpretation disagree, because they assume “different normative theories about what literature is and what it is for and about what makes a work of art better than another.”⁹ This is the first assumption of the aesthetic hypothesis.

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⁸ Above, 152.
⁹ R. Dworkin, above note 3, 534.
The second one is the supposition that there is a sharp distinction between explaining a work of art and changing it into a different one. In relation to Hamlet, it is possible for one to contend that Shakespeare could have written a better play if the hero would have been a more decisive man. From that it does not follow that Hamlet -the play Shakespeare did actually write- is like that. Contemporary theories of interpretation use as part of their response to the requirement of the identity of the text the notion of canonical text. Indeed, in the name of identity, the text circumscribes the scope of available interpretations in the sense that interpreters are not allowed to ignore words that are contained in the text or change them. But the presence of text is not the only source of restrictions. Other constrains include considerations about the integrity and coherence in literature as a form of art.

All these constrictions represent different points of potential disagreement. Yet, interpreters do not simply disagree on formal or quasi-formal aspects of Hamlet. According to the aesthetic hypothesis, there is a deeper level of disagreement, a divergence of views concerning the point and function of art broadly conceived. As Dworkin puts it, works of art “do not exist in isolation from philosophy, psychology, sociology and cosmology”. For example, someone who accepts Feminism will probably have a different theory of art from someone who does not. Similarly, a director cannot defend a staging of Hamlet that is strictly faithful to the historical context of the play, unless he subscribes to a sub-theory about the point and function of art, according to which what is valuable in classical theatrical plays is their reference to a particular historical era.

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10 R. Dworkin, above note 3, 531. On this account interpretation resembles to that of a chain novel in progress where each subsequent author is constrained by what has been already written by his predecessors in the sense that he must produce something that forms an organic whole with the previous chapters while making the entire novel the best it can be. See also, D. Litowitz, ‘Dworkin and Critical Legal Studies on Right Answers and Conceptual Holism,’ 18 Legal Studies Forum (1994), 135 at 143.

11 In the case of music interpreters have as point of reference the canonical score, while in painting and sculpture a unique physical object.
Clearly, the interpreter relies both on beliefs of a theoretical character about identity and other formal properties of the piece of literature under interpretation as well as on more explicitly normative beliefs about what is good in art.\textsuperscript{12} Normative beliefs are ingrained in the structure of interpretive argument and so does evaluation in the course of interpretation. Consequently, another feature of the aesthetic hypothesis is that it does not endorse the frequently made sharp distinction between interpretation conceived as discovering the real meaning of a work of art—\textit{Hamlet}, in our case—where evaluation is supposedly absent, and criticism, conceived as evaluation of this success or importance.\textsuperscript{13} Evaluative beliefs about art figure in both cases.

That the aesthetic hypothesis is attentive to the presence of evaluation in interpretation does not entail that the aesthetic hypothesis subscribes to the sceptical view, according to which interpretive judgements in art cannot be \textit{objectively} true or false.\textsuperscript{14} Specifically, the aesthetic hypothesis takes a very careful approach to the issue of objectivity.\textsuperscript{15} Although it accepts that no important aesthetic claim can be demonstrated to be true or false and that no interpretive argument can be produced that we can be sure that it will receive universal acceptance, it contends that it does not follow that no

\textsuperscript{12} Nonetheless, the interpreter need not consciously and fully adhere to a particular theory of art. What is important here is that the interpreter has genuine beliefs and not merely “reactions”. R. Dworkin, above note 7, 151-152.

\textsuperscript{13} R. Dworkin, above note 7, 153. Many scholars draw this distinction because they are not comfortable with the presence of evaluation in interpretation. In their view evaluation is subjective and prejudiced and, therefore, erodes the real meaning of the text. O. Fiss, ‘Objectivity and Interpretation’, \textit{34 Stanford Law Review} (1981-1982), 739.

\textsuperscript{14} It follows that the aesthetic hypothesis must not be confused with a very popular theory in the field of literature whose core postulate is that since interpretation creates a work of art and represents only the fiat of a particular critical community there are only interpretations and no best interpretation of any particular poem novel or play. A prominent advocate of this view is Stanley Fish.

\textsuperscript{15} Objectivity in the context of law (including regulation) should be understood as accommodating creativity, disagreement and error. Above note 13, 747-748.
normative theory about art is better than any other, nor that one theory cannot be the best that has so far been produced.\textsuperscript{16}

In the same vein, the aesthetic hypothesis claims that in light of the public nature of the enterprise of interpretation, we should not assume a priori that interpretive statements must be capable of validity or what validity in interpretation is like (for example, whether validity requires the possibility of demonstrability). Instead, it is better to approach questions of validity in a more empirical manner by studying, first, “a variety of activities in which people assume that they have good reasons for what they say and which they assume that these reasons hold generally and not just from one or another individual point of view” and, then, judging “what standards people accept in practice for thinking that they have reasons of that kind”.\textsuperscript{17}

Finally, the aesthetic hypothesis draws a sharp distinction between what a work of art \textit{is} and what the interpreter believes or intends it to be.\textsuperscript{18} In this manner it acknowledges as part of the practice of interpretation the fact that the interpreter treats a work of art as an object that exists independently from his initial beliefs and world-views. Moreover, it makes space so that the interpretation of a work of art is constantly revised and, when found mistaken due to the presence of false beliefs, remedied appropriately.

To sum-up the aesthetic hypothesis comprises the following claims: (a) Theoretical accounts of interpretation in literature are candidates for the best answer to the substantive question posed by interpretation rather than candidate analyses of the notion of interpretation; (b) disputes about the proper interpretation of a work of art involve normative disagreement about

\textsuperscript{16} The question of objectivity is one of the most puzzling topics in the fields of law, ethics and philosophy of language. This is further discussed in the next chapter.

\textsuperscript{17} Above note 7, 153-154.

\textsuperscript{18} Above, 157-158.
the point and function of art in general, alongside disagreement about formal or quasi-formal aspects of the work of art in question; (c) there is a sharp distinction between making sense of a work of art as it is and changing it into a different one, given that in the former case considerations about the identity of the work of art as well as about integrity and coherence in literature impose firm constraints on interpretive discretion; and (d) the interpreter treats the work of art as an object that exists independently from one’s personal beliefs and intentions. In this manner he acknowledges the possibility that his understanding of the object of interpretation may turn out to be mistaken and therefore in need of revision and change.

2.2. Interpreting a piece of literature

Here is how the aesthetic hypothesis works in the field of literature. Suppose that there is a group of three young directors –Tom, Stuart and John- who take directing very seriously and have the ambition to make a new staging of Shakespeare’s *Hamlet*. Among the things that they need to do is to interpret *Hamlet* in order to decide issues about the staging of the play. They have to answer questions that give rise to a host of interpretive arguments. They must take a stance as, to what extent the overall setting of the play must be faithful to the historical era of the play, whether the actors should ‘mime’ notions or directions that figure in the narrative of the play, and whether it would be a good idea to arrange conjunctions and line endings in such a manner so that the audience, as they go on attending the play, develop contradictory assumptions so that at the very end their understanding of *Hamlet* is different from what it was at discrete points

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19 I deliberately imagine a group of directors instead of one director acting on his own, in order to make this fictitious situation resemble an interpretive community. This term is used loosely and interchangeably with the term “community of interpreters” or “regulatory community”, unless otherwise specified. In any case participation in the interpretive community should be seen as open-ended so that progressively expands and engulfs theatrical critics and even members of the audience.
along the way. How they will decide these issues will depend on how they will conceive the character of the heroes (Is Hamlet indecisive or schizophrenic prince?), the nature of their relationship (Does Gertrude suspect that Claudius killed her husband? Does Gertrude marry Claudius out of interest or because she is deeply in love with him?), and the point of the play (What is the central message of Hamlet? To depict the insane state of mind of the prince of Denmark? To make a statement about the wickedness of political corruption? To condemn the presence of social inequality and oppression between sexes?).

In answering these questions, one might suggest that the group of young directors will interpret the play in a manner that will guarantee its commercial success. Urged by their interest to gain quick fame and money, they will interpret the text with the view of “putting in” things that in their belief will please the audience and hopefully keep critics happy. On that view, the point of interpreting Hamlet is to offer an understanding of the play that it will be agreeable to the viewers’ tastes. Despite the plausibility of this account, in my view, it is a mistake to say that the whole point of interpreting Hamlet is to propose ‘an understanding of the play that it will be agreeable to the viewers’ tastes’ because, in this case, it is unlikely that the directors take their job seriously. Suppose that you are a fan of theatre with a special interest in Shakespeare’s plays and you have a friendly chat with the directors of my example. At some point you are told that they decided to stage Hamlet in such a way so that in the famous scene where Claudius is preying, Hamlet does not abstain from killing him. In hearing that, you react in the following manner: “You know what? This is an interesting idea, but with all due respect I don’t think that this is the best interpretation of the

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21 An alternative suggestion might be that the directors want simply to express themselves. This, however, would mean that the directors are not interested in staging Hamlet but in creating a new play inspired by Shakespeare’s famous play.
play because—if anything—Hamlet is supposed to be indecisive throughout the play.” If the directors defend their decision by saying “Well my friend perhaps you are right but we want to reassure the audience’s sense of justice and what a better way to do so by satisfying the audience’s appetite for violent and bloody scenes. There is no doubt that if we became famous we would owe our fame to this scene!” I am sure you would have good reasons to feel disappointed and to think that the directors of my example do not show the proper respect to the theatrical play.

The reason that I invited you to imagine this fictitious chat is to make plain the following point: That if John Stuart and Tom are really serious on what they are doing, than their priority should be not to please the audience or to become celebrities but to take care so that their interpretation of Hamlet does not compromise the aesthetic value of the play as a piece of art. Although there is nothing wrong in having personal ambitions and pursuing individual interests, it is the nature of directing that requires from those practising it to respect the object of interpretation and develop a sense of duty—a commitment that they will do the best possible to get the meaning of the play ‘right’. Were we to apply a theory of interpretation that would allow interpreters (acting individually or jointly as members of a community) to do whatever they wanted to do out of a piece of art, we would be bound to miss this important aspect of interpretation in literature namely, the fact that it makes certain demands to its practitioners to the effect of recognising that a piece of art has value that stands independently of whether it serves other purposes as, for example, financial gain, or social order.

In my example, I also suppose that the directors wish to interpret Hamlet with the view of gaining a deeper understanding of the play as it is that is,
their aim is not to create a new theatrical play inspired by the original one.\textsuperscript{22} It follows that part of their task is to depict the character of Hamlet – the main hero – as it is and not to change it into a different one.\textsuperscript{23} This means that, if they eventually come to believe that Shakespeare would have written a better play if the hero would have been a man of action rather than a man of words and gestures, this belief is irrelevant because it does not follow that \textit{Hamlet}, the play that Shakespeare did actually write is like that. Similarly, if in the directors’ opinion Shakespeare would have ended up with a superior play if he had stressed and condemned the social inequality between men and women in medieval Denmark, this does not mean that this is the theatrical play that Shakespeare wrote. Their attitude towards \textit{Hamlet} leaves beyond doubt that in the course of interpretation, the directors treat the work of art as an object that exists independently from their intentions and world-views.

The difference between interpreting a work of art and change it into a different one bears with it the following implication. To the extent in which directors wish to stage \textit{Hamlet} and not a different theatrical play that will be inspired by the original play, they are bound to attend certain restrictions. The \textit{identity} of the work of art under interpretation, namely the fact that the directors are dealing with a text that happens to be a theatrical play rather than a novel or a poem, is one of them. Up to this point it is important to recall that they wish to stage \textit{Hamlet} as a theatrical play. They do not aspire, for example, to adapt the text of the theatrical play so that it eventually becomes a philosophical novel to be read aloud in front of an audience. The identity of the text suggests that the directors are not free to ignore the words of the text or to change them.\textsuperscript{24} \textit{Coherence} and \textit{integrity} provide another

\textsuperscript{22} Recall that despite their personal aspirations “they take directing seriously.” See the discussion above at page 205.
\textsuperscript{23} Above note 7, 150.
\textsuperscript{24} Above.
set of restrictions to their interpretive style. No matter how much they aspire to make the staging of *Hamlet* an eminent piece of art, it is profound that the directors will have to avoid interpreting *Hamlet* in a manner that will make a large part of the text irrelevant. Accordingly, in their attempt to provide an interpretation of *Hamlet* that justifies the aesthetic value of the theatrical play as much as possible, the directors are not allowed to transform it from a theatrical play into -say- a philosophical novel, by virtue of their belief that a philosophical novel is aesthetically more valuable than a theatrical play. If this were the case, than the interpretation of *Hamlet* would fail because the interpretation would make the philosophical novel a mess not least because the organisation, style and figures would be appropriate for an entirely different genre.\(^{25}\)

The analysis above makes plain that there is a host of sources of constraints that interpreters must observe while interpreting a piece of art. However, one might object this claim and argue instead that in reality there are no limits when interpreting a piece of art like the theatrical play of our example.\(^{26}\) His protest could be captured in the following statement: “You are right in identifying a range of other factors –“constraints” as you call them- that mould the interpreters’ grasp of the text. You fail to see, however, that the interpreters’ (the directors, in my example) perception of these factors (text, integrity, coherence) relies upon their subjective world-views, which are relative to their cultural upbringing. Furthermore, you fall short from realising that whether they will be taken into account and to what extent they will draw the line between acceptable and non-acceptable interpretation of *Hamlet* depends entirely on their subjective judgements.

\(^{25}\) The fact that this reinterpretation can be successful in some cases but not in others reaffirms further the constraint of integrity. R. Dworkin draws example from Agatha Christie’s stories and Raymond Chandler to illustrate this point. Above note 7, 150-151.

\(^{26}\) Although I consider this objection in more detail in the next chapter, I feel that I should say a few things in advance, as this will allow me to shed light in a number of other aspects of the practice of interpretation that arguably should inform any theoretical framework of regulatory interpretation.
The restrictions that you identify are not out there in the world. They are made by the interpretive community (John, Stuart and Tom or more broadly the professional community of theatrical directors), within which the interpreters interact. They are “constraints” insofar as and to the extent in which the members of the interpretive community recognise them as such.”\textsuperscript{27}

There is no doubt that the directors’ beliefs about interpretive constraints are relative to cultural upbringing and the community in which they live. Similarly, claims about constraints and their ensuing interpretive arguments are subjective, if what we mean with the term ‘subjective’ is something that we cannot demonstrate to be true or false in the same way we can demonstrate for example that it is summer in the physical sciences. It is a mistake, however, to hold that we cannot really tell whether one interpretation is better than another, because by doing so we are bound to deny the possibility of a genuine debate about issues of interpretation and with that the possibility that interpreters can be mistaken in their views or their capacity to reflect on their views and revise them after rational judgement. To put it differently, the issue here is not whether the interpreters’ beliefs are subjective and relative (of course they are) but whether it is intelligible to say that interpreters can rationally debate matters of interpretation as, for example, whether it is a right or wrong to regard a particular consideration as eligible limit to their interpretive discretion.\textsuperscript{28}

\textsuperscript{27} To be precise, Fish argues that constrains over one’s interpretation come from consensus among members of the interpretive community. His point is that if the interpretive community in which I belong says that “x” is a “cycle” then, I am not free to call “x”, “square.” I am not free, in the sense that my interpretation will automatically be rejected by the interpretive community in which I partake. S. Fish, above note 3, ‘Working in the Chain Gang: Interpretation in Law and Literature’, 555 and; ‘Wrong Again’, 60 Texas Law Review (1983-1984), 299. In this manner he tries to disassociate himself from proponents of the idea that “anything goes” as, for example, Sanford Levinson (see above note 3). However, the successful of his endeavour is questionable. R. Dworkin, ‘Don’t Talk About Objectivity Any More’, above note 6, 295.

\textsuperscript{28} Owen Fiss proposes a thought-provoking thesis about how the notion of objectivity should be understood in the context of law. He argues that essentially objectivity in law “connotes standards.” He
This point becomes clear once we consider how we actually think of two people debating the interpretation of a piece of art. Despite the fact that their views are informed by their cultural and social background, their disagreements about interpretation are genuine in the sense that there is always a case that they are trying to support or object.²⁹ We also regard them as generally able to identify mistakes and correct them through rational deliberation. Moreover, we think that the worth of an argument does not depend entirely on the identity of the person that expresses it. For instance, if one of the directors said that “we should highlight the frustration of Gertrude and Ophelia in the play, so that to make a point about female oppression” you would think that a response of the sort “well, he says that because he is a feminist” to be beside the point, for the question here is not a question of biographical fact (“How it comes and he holds this view?”), but a question of value (“What kind of interpretation makes Hamlet the best possible play it can be? Is it true that if we highlight female frustration, we will make Hamlet the best possible play of its genre?” “Is it true that if we put emphasis on female frustration, we will justify the aesthetic value of the play in the best possible way?”).

To conclude the advocate of the idea that there are no real constraints to circumscribe interpretive discretion for the community of interpreters has de facto authority over what is going to count as acceptable (or non-acceptable) interpretation wants us to stop insisting on the presence of interpretive constraints, for otherwise we are bound to get trapped into a theoretical account of interpretation that commits us to accepting an absurd world-ontology. I argued that were we to follow this view of interpretation,

we would be bound to make interpretive debate look unintelligible. Consequently, the case against the presence of interpretive constraints is unfounded.\textsuperscript{30}

The analysis so far worked on the assumption that the theatrical play is treated as an object of interpretation that stands independently from the director's intentions.\textsuperscript{31} This seems to contradict with a very popular view according to which there is no space between the object of interpretation and what the author or the reader intends it to be.\textsuperscript{32} There is something deeply problematic in this widely accepted thesis. If we assume that at some point John and Stuart claim that \textit{Hamlet} is about death and Tom disagrees with them because in his view \textit{Hamlet} is about political corruption, they do not disagree on the content of their utterances -what Tom believes \textit{Hamlet} to be or to what John and Stuart believe \textit{Hamlet} to be, as the popular view assumes. They disagree about what \textit{Hamlet} as a theatrical play \textit{is}. To say that disagreement about the object of interpretation is a façade suggests failure to appreciate that to treat a work of art independently of one’s intentions constitutes integral part of the practice of artistic interpretation. Moreover, it indicates a deeper misconception of how intentions for a work of art like a theatrical play and beliefs about it interact.

To appreciate the interaction between intentions and beliefs, let’s suppose that after a long time of preparation the group of directors in my fictitious scenario stage \textit{Hamlet} with some success. Suddenly in the seventh performance of the play they start seeing something “in” \textit{Hamlet} that they

\textsuperscript{30} This point is further discussed in Chapter Six.
\textsuperscript{31} See below Chapter Six.
\textsuperscript{32} S. Levinson, above note 3, 373; and G. Graff, 405. Professor Fish is also an enthusiast of this view although with a twist. He argues that the interpreter's intentions are manifestations of the shared understanding of the interpretive community in which he belongs and on that basis he concludes that the text is the product of a particular interpretive community. S. Fish, 'Interpretation and the Pluralist Vision, above note 3, 503.
did not notice before. The central hero, Hamlet, shows towards Gertrude a kind of affection that is unusual in a relationship between mother and son. Thus they start to interpret Hamlet’s fragile mental state and his motivation to seek revenge very differently. In their mind Hamlet no longer figures as a young man who became mentally ill as a result of his father’s murder and who now wishes to take revenge for his father’s death. Rather, Hamlet figures as a mentally unstable young man due to his repressed sexual feelings for his mother Gertrude. His thirst for blood, his unhappiness and indecisiveness, all spring from Oedipus complex.

What is it that has actually happened in the minds of the directors? Those who insist that directors in reality pretend to disagree about Hamlet want us to choose between two possibilities. To assume that either the directors suddenly realized that they had a “subconscious intention” earlier, which they only now discover, or they have changed their intention later. Neither of these suppositions seems to work in practice. The claim about the presence of a subconscious intention, cannot work, unless we are prepared to accept that, apart from the directors’ views, there is some independent evidence –as of the kind a psychologist would require- for otherwise the explanation would rest on unproved premises. This is not crucial to the point, however. To borrow from Dworkin once again, the directors’ decisions and beliefs about the character of the hero are not the outcome of the directors’ confronting their earlier decisions and beliefs but the outcome of the directors’ confronting the work they have produced. By the same token, it is not accurate to call the directors’ revised beliefs about Hamlet’s character new and discrete intentions, because these are beliefs about the character they have created and not “intentions” about what sort of

33 Above note 7, 154-158.
34 Above, 157.
character to create.\textsuperscript{35} In short, Tom, Stuart and John changed their views about the character of Hamlet in the course of staging the play by interpreting Hamlet rather than by exploring the subconscious depths of some previous plan or finding that they had a new plan.

This brings the discussion to a further and much more crucial point. Similarly to an author, a director (or a group of directors as the case might be) “is capable of detaching what” he has created “from his earlier intentions and beliefs”. He has the capacity to treat his creature “as an object” in itself and reach “fresh conclusions about his work grounded in aesthetic judgements”.\textsuperscript{36} Accordingly, any full description of what the directors intended, once they set out to stage \textit{Hamlet}, must include the intention to produce something capable of being treated that way, by themselves and therefore by others, and so must include the intention to create something that is independent of their intentions.\textsuperscript{37} With other words, although we can isolate the full set of beliefs that the group of directors have at a particular point of time (say, at the premiere of \textit{Hamlet}) and declare that these beliefs fix what \textit{Hamlet} is about, it is inaccurate to call these beliefs “intentions”. Furthermore, it is inappropriate to choose them as point of reference for our interpretation of the theatrical play because, in doing so, we are bound to ignore “another kind or level of intention, which is the intention to create a work, whose nature or meaning is not fixed in this way, because it is a work of art.”\textsuperscript{38}

To recapitulate, in this section I overviewed the practice of interpretation in literature in light of the aesthetic hypothesis. It was suggested that the

\textsuperscript{35} Above, 157.
\textsuperscript{36} R. Dworkin, above note 7, 157.
\textsuperscript{37} R. Dworkin, above note 3, 539-540. He further develops these points in ‘Don't Talk about Objectivity any More’ in W. J. T. Mitchell (ed) \textit{The Politics of Interpretation} (1983), 287.
\textsuperscript{38} Above note 7, 158.
subject matter of interpretation in literature is the work of art itself rather than the interpreters’ utterances of how they understand it. The point of interpretation is to make the work of art the best it can be. In doing so, those who interpret it are attentive to a range of considerations including the identity of the work of art, artistic integrity and coherence. Moreover, the discussion brought into the surface another feature that is integral in the practice of literary interpretation. It revealed that interpreters have a very special attitude towards the work of art; they treat it as an object that exists independently from their intentions and beliefs, so that to allow space for mistake and correction through rational criticism and deliberation.

Does interpretation in literature differ from interpretation in law—in particular regulation? Provided we can show that interpreters in the regulatory context (a) try to make sense of regulatory requirements rather than each other’s utterances; (b) they are concerned with getting the interpretation of rules “right” over and above attaining some sort of interpretive convergence; (c) develop a particular interpretive attitude and (d) pay special attention to a number of considerations including those of the identity of the regulatory text, integrity and coherence, then we can reasonably argue that interpretation in literature and interpretation in regulation are identical in several crucial respects and, on this basis, propose that any candidate theoretical account of the nature of regulatory interpretation must be attentive to these features. This issue is discussed next.

To put it differently, the group of directors in our example do not try to answer questions like the following: “What Tom makes of Hamlet?” or “What is it that fuels Tom’s understanding of Hamlet?”
3. Comparing interpretation in literature and interpretation in regulation

Here is how literary interpretation can provide us with a framework for modelling the practice of interpretation in regulation.\(^{40}\) Literary interpretation aims at showing how a work of art can be seen as the most valuable work of art of its genre and so must attend to formal features of identity, coherence, and integrity as well as to more substantive considerations of artistic value. In a parallel way regulatory interpretation can be seen as purporting to make the best possible sense of the rule in question and, therefore, must take into account formal features of identity, integrity and coherence as well as its point or value. Similarly to literary interpretation, some conception of integrity and coherence in regulation will guide the interpreters’ understanding of the point or function of a particular set of rules (COB in our case) by way of circumscribing their convictions about how much an interpretation must fit prior interpretive decisions, which of them and how. It is profound that the point of value in the case of regulation cannot mean artistic value, because, unlike literature, law (and the institution of law includes rule-based regulation) is not an artistic enterprise. Law is a political enterprise, whose general point lies in coordinating social and individual effort, resolving social and individual disputes and overall securing justice.\(^{41}\) Accordingly, any interpretation of any branch of law (including regulation) must show the value of that branch of law “in political terms by demonstrating the best principle or policy it can be taken to serve.”\(^{42}\)

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\(^{40}\) Above note 7, 158-162 and; R. Dworkin, note 3, 540-550.

\(^{41}\) In the context of regulation some of these features –for example, the advancement of social and individual coordination- are more conspicuous than others.

The exploration of the practice of interpretation in literature made plain that evaluation is not a licence for the interpreter to make what ever he wishes from the object of interpretation. The same holds with respect to interpretation in the regulatory context.\textsuperscript{43} The regulatory community has a duty to interpret the regulatory history it finds not to invent a new one. In this vein it is bound to attend to formal features of identity, coherence and integrity as well as more substantive considerations of political value. Significantly, in performing this duty, interpreters are not infallible. Mistake is ingrained in the practice of interpretation and so it does the possibility of correction.

Similarly, those involved in the interpretation of rules will frequently fail to produce a single interpretation of the rule in question exactly the same way as the directors in my case study failed to suggest a single reading of \textit{Hamlet}. In the event where different interpretations find sufficient support in the text, substantive political theory will provide guidance as to which one to choose. Simply put, the interpretation of COB (z'), that the requirement of explicitness must be broadly understood, is probably better interpretation only insofar as it states a sounder principle of justice than any principle that distinguishes between written and oral communication.\textsuperscript{44}

Finally, as with interpretation in literature, the opinions expressed in the regulatory context about the best interpretation of regulatory norms will be founded on different beliefs about the point or value of regulation in general—beliefs that other members of the regulatory community need not share. For example, those members in the community who believe that the dominant purpose of regulation is some sort of economic efficiency, will detect in the past interpretations of conduct of business regulation, some

\textsuperscript{43} On the presence of constraints over interpretation see above note 13, 744-745.

\textsuperscript{44} This is essentially an issue of political morality. Above note 29.
strategy of reducing the economic costs of transacting with unsophisticated investors overall. But other members of the community may reject the claim that COB rules purport to cut transaction costs because, in their view, the main objective of regulation is not to promote efficiency but to ensure that the parties in market transactions are treated as equals.

To conclude, literary interpretation and regulatory interpretation coincide in a number of crucial respects. Consequently, a theory of regulatory interpretation must be similar (although not identical) to a theory of interpretation in literature that embraces the insights of the aesthetic hypothesis and as such accounts for the subject matter, purpose of interpretation and interpretive authority in a manner that makes interpretive disagreement genuine and intelligible. To this end, it is essential that it makes room for mistake and more generally it is sensitive to the special manner in which interpreters approach the object of interpretation. Below, I turn to the communicative theory, in order to assess the extent to which it meets these threshold conditions.

4. A fresh look at the communicative theory of regulatory interpretation: Some difficulties

A considerable part of this chapter was devoted in exploring the practice of interpretation in general as an intellectual enterprise that can be practised in various contexts including that of literature. The aim was to gain a deeper

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understanding of this practice. Now that I have explicated at some length a number of key issues such as the point of interpretation, the difference between interpreting and changing the object of interpretation into something different, the dual nature of interpretive arguments (both descriptive and evaluative), the function of interpretive constraints and the difference between beliefs and intentions, it is about time to move on and consider some difficulties that are inherent in the communicative thesis of regulatory interpretation.

To start with, there is a striking difference between the picture of regulatory interpretation under the communicative theory and the outlook of regulatory interpretation that emerges from the comparative study of interpretation in literature and in law. Accordingly, if one wishes to insist on the communicative reading of regulatory interpretation, he must convincingly demonstrate that, despite this discrepancy, we have good reasons to subscribe to the communicative model of regulatory interpretation—say, for example, because it is better able to work in practice and/or more suitable to offer an attractive portrayal of the practice of interpretation in the regulatory context. It is argued that despite its initial appeal the communicative theory fails on both fronts.47

Specifically, one of the core postulates of the communicative thesis is the supposition that meaning depends on the interpreters’ intention. This seems to be problematic. Given that the interpreters in the communicative theory are taken to act as members of a community48 and their intentions are considered significant in light of their membership, we have two options. The first option is to say that a regulatory interpretive community is a kind

47 The appeal of the communicative theory of regulatory interpretation was examined in Chapter Four above at pages 190 to 193.
48 Above Chapter Four, note 14.
of a mysterious entity with an intention on its own. The second option is to acknowledge the absurdity of the earlier claim and explain that when we are talking about the intentions of the regulatory interpretive community what we really have in our minds is the intention of the prevailing interpreter, who sets the tone of the interpretive strategy for the whole regulatory interpretive community.

The second option is too complicated to work in practice. Of course, we may suppose that the regulator is the prevailing interpreter, since at the end of the day it is the regulator that is officially responsible for deciding matters of interpretation. However, the regulator’s prevalence is not self-evident. For example, one could argue with equal force that it is the legislator’s intention that dominates the regulatory community, pointing to the fact that the regulator acts upon a statutory mandate, which must always observe, or that the regulator is expected to give voice to the views of all the members of the regulatory interpretive community and, therefore, it should interpret rules in a manner that is consistent with the intentions of the regulatory interpretive community collectively. Alternatively, one could even suggest that the interpretive intention that is crucial here is that of the judiciary, because only judges are constitutionally fit to decide conclusively matters of legal interpretation. Finally, a fourth option is to say that, as a matter of

49 Above note 4, chapter 9, particularly pages 313-327.
50 This position seems to be favoured by Black. As she contends: “... rules are not literally texts where the more meaning and interpretation that can be found the better; for rules, only one interpretation will be accepted as 'correct'. For the rule to 'work' in the sense of being applied in a way that would further the overall aims of the regulatory system, then the person applying has to share the rule maker's interpretation of the rule; they have to belong to the same interpretive community.” Julia Black, Rules and Regulators (1997), 30 and 34-35; and ‘Using Rules Effectively’ in C. McGradden (ed), Regulation and Deregulation (2000), 95 at 101.
51 Provided of course that it is possible in some way to resolve the ensuing problem of commensurating the various points of views expressed by the each one of the members of the regulatory community. On the persistent problem of commensurability see notably, D. Wiggins, “Weakness of Will, Commensurability, and the Objects of Deliberation and Desire”, in Needs, Values, Truth: Essays in the Philosophy of Value (1998); B. Williams, “Conflicts of Values”, in Moral Luck (1981).
sheer fact, the interpretation of regulatory norms is always influenced by the dominant interest group’s intention that happens to take the regulator on its side.\footnote{D. C. Mueller, \textit{Public Choice III} (2005), ch.15.} Whatever the case, the fact of the matter is that the prevalence of the regulator’s intention should not be taken for granted. Yet, even if we could unequivocally argue in favour of the regulator’s intentions, still this would be of little help. Regulatory bodies and organs do not have intentions, individuals have intentions, and in the absence of a theory to guide our choice, we would be unable to decide whose intention to pick up. So, to cut a long argument short, the idea that we need to discern someone’s intention if we hope to make sense of a regulatory requirement is not of much help because it leads nowhere.\footnote{Above note 4, 321-327.}

A further issue that makes things even more complicated is the fact that interpreters’ typically have more than one interpretive intentions.\footnote{See the discussion on the 14th Amendment of the US Constitution and the racial segregation of schools; in particular, the exposition of historicism as an interpretive approach to the US Constitution. Above, 359-363.} To make this point clear let me return to the example of regulatory interpretation that I discussed earlier in order to show how –according to the communicative theory of regulatory interpretation- the members of the regulatory interpretive community go about in interpreting a rule. My hypothesis was that the regulator wishes to bring the selling of personal pensions in line with the selling of other packaged products and proposes to replace COB (z) with COB (z'), so that ‘tied financial advisers’ that deal with consumers will no longer have the obligation to compare personal pension contracts with products and services that fall outside of their range before recommending them, unless their customer \textit{explicitly} requires for them to do so. Suppose rule COB(z) is now replaced with rule COB (z'), which is coupled with guidance COB (G) clarifying that communication via email...
satisfies the requirement of explicitness set out by COB (z') (but remaining silent on whether ‘oral communication’ does the same). Initially the application of COB (z') raises no issues of interpretation, however, after a while the following problem crops up. Having relied on the letter of COB(G), several tied financial advisers ignored oral communication with their clients and recommended personal pension contracts as suitable for their clients from their own range of products and services. Now they are faced with the risk of a legal suit and possibly the obligation to pay a huge amount of compensation.

In relying on the letter of COB (G), the financial advisers of our example acted honestly. They seriously thought that, since the intention of the regulator is to bring the selling of personal pension contracts into line with the selling of other packaged products, COB (G) had to be strictly interpreted. However, consumers hold a totally different view about the proper interpretation of COB (G). They do not dispute the fact that the regulator wanted to bring the selling of personal pensions into line with other packaged products, they point out, however, that the regulator’s intention in regulating conduct of business with consumers has always been the protection of consumers and therefore COB (G) should be interpreted as broadly as possible so that, despite the letter of COB (G), adherence with the spirit of the regulatory requirement is secured. The fact that financial advisers and consumers identified two distinct intentions rather than one behind the regulator’s drafting of COB (z’) and COB (G) signals out the presence of more than one intentions. So even if we assume that the intention of the regulatory interpretive community should identify with the intention of the regulator, for once again we are bound to return to square

56 The problem is that if COB(G) is strictly interpreted, then consumers (probably the least educated, who are in need of protection more than anyone else) who ask orally their suppliers to take into account personal pensions outside their own range of products will not be protected because “oral communication” does not fall within the scope of “explicitness” of COB(G). This is a standard example of under-inclusiveness (the rule covers less cases than it was initially intended) and creative compliance. D. McBarnet and C. Wheelan, ‘The Elusive Spirit of Law’, 54 Modern Law Review (1991), 409.
one, given that we need to decide which one of the two intentions we should follow.

The problems with the communicative theory do not stop there. What I said so far in relation to the centrality of the interpreters’ intentions in defining the meaning of rules challenge with equal force the supposition that authority lies with the community in which interpreters interact, for this claim works provided that we can overcome the difficulties that are associated with identifying the intentions of the regulatory interpretive community. However, there are additional reasons to cast doubt to the claim that the regulatory interpretive community is the only source of constraints over the exercise of interpretive discretion. Those who endorse this idea are moved by the belief that truth (and its opposite) is ‘man-made’; that truth is simply a matter of convention, something to be determined by the prevailing norms, beliefs and attitudes of a particular interpretive community. In their view, not only does the interpretive community define what is to count as ‘right’ (or ‘wrong’) interpretation, but also defines other considerations that may confine interpretation (for example, what is the kind of text under interpretation and whether and to what extent should the text preclude certain interpretations as ‘non-appropriate’). For the moment I cannot explain in full why scepticism about interpretation is a flawed thesis. I will limit myself by saying that despite its plausibility, scepticism is not at all consistent with the way we normally think about interpretation and interpretive disagreements. For example, scepticism about interpretation entails that people cannot be mistaken in their interpretive-judgements. Members of the regulatory community may find some interpretations distasteful but they have no ground for saying that those who hold them have made a mistake. Similarly, scepticism about interpretation assumes that

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58 This issue is considered in Chapter Six below.
interpretive judgements are nothing more than reports of the speakers’ subjective beliefs and prejudices. Accordingly, debates about interpretation are nothing more than an exchange of reports of the co-discussants’ psychological states and, consequently, disagreements about interpretation – as, for example, the disagreement we have been examining a few paragraphs above on the proper interpretation of COB (z’)- have no subject matter, for there is nothing that members of a regulatory community actually disagree about.

The difficulty with scepticism emerges, when we attend the way we normally think about interpretation and interpretive disagreements. For example, we actually tend to think that people can be mistaken in attributing a particular meaning to a rule and that they are generally able to identify and correct this mistake through rational argument. We believe that people’s disagreements are genuine in the sense that there is always a case that they are trying to support or object. We also think that the worth of an argument does not generally depend on the identity of the person who expresses it; if someone said that “it is a mistake to interpret COB (G) literally”, we would find a response of the kind “well, you say that because you represent consumer interests” beside the point, for the question we are interested in finding an answer is not “why does he say that” as a matter of biographical fact, but whether in the given circumstances it is true to say that the requirement of explicit communication set out in COB (z’) is not satisfied in case of oral communication.

This last point brings me to the third assumption that permeates the communicative theory of regulatory interpretation namely, the claim that the point or objective of regulatory interpretation is not to ensure that rules receive correct interpretation but to work towards achieving the most
agreeable interpretation (interpretive convergence). In light of what we said so far on the possibility of mistake, it seems to me that it is odd to assume that the only thing that interpreters care of is to reach consensus. To return to my earlier example where those involved in the regulatory system disagree about the interpretation of the term ‘explicit communication’ contained in COB (z’), it is worth noticing that the financial advisers, who got into trouble by relying on the letter of COB (G), do not simply want to make others agree with them. Rather, provided that they are serious on what they are doing, they hope that through sound reasoning they could help their co-discussants see their point, identify their mistake and revise their views accordingly. The same observations apply with equal force to consumers. Both sides of the debate ask: “Does oral communication satisfy the requirement of explicitness set out by COB (z’)?” Both sides of the debate have a genuine interest in finding out whether the proposition “Oral communication satisfies (or does not satisfy) the requirement of explicitness set out by COB (z’)” is true or false. They do not ask: “What kind of interpretation is most likely to appeal to my co-discussants?” or “What mode of action should I take to persuade them that I am ‘right’/take my side?” By saying that I do not mean to deny the role of persuasion in shaping the final interpretive judgement. My purpose is twofold: On the one hand, to refute the sceptical foundation of persuasion, on the other hand, to suggest that—for the purposes of mapping the nature of regulatory interpretation—persuasion should be understood as rational deliberation among individuals that are capable of reason rather than a manifestation of power politics in the regulatory arena.59

Finally, special attention should be given to the role of the regulator. There is no doubt that the regulator is interested in making sure that the regulatory

59 If our purpose were to explain regulatory failure in interpreting rules appropriately, then it would be a point to offer an account of persuasion in terms of power politics.
process—especially when it relies so much on the use of legal rules—works in the sense that precious time is not wasted in endless debates about interpretation.\textsuperscript{60} To say, however, that procedural efficiency is his sole concern amounts to turn a blind eye to several features of regulation that suggest otherwise.\textsuperscript{61} Institutional configurations and other practices that aim to keep the regulator accountable, for example, consultation, publication of various communications and judicial review—to mention a few—suggest that a distinct characteristic of our political culture (and the institution of law and regulation is part of this culture) is that we place value in getting the interpretation of rules ‘right’ and the case of regulation seems to be no exception. Taking all this into account, it is suggested that due to his task to decide matters of interpretation in the course of his public office, the regulator holds a special duty to guard against interpretive mistakes. Moreover, the regulator has a special duty to opt for an interpretation that goes against the popular view, if he has strong reasons to believe that the popular view is mistaken. So to cut a long argument short, the regulator’s job is not to keep his audience happy but to give reasons for his interpretive judgement, reasons that are eligible to justify the legality of rules as much as possible. Of course, I am not suggesting here that the regulator should see himself in the shoes of a judge, who after all is the only one institutionally delegated to resolve legal disputes and decide questions of interpretation conclusively. What I am saying is that in light of the fact that, the regulator is entrusted with the power to use rules in order to implement policies he

\textsuperscript{60} Considerations of procedural efficiency need not compromise the integrity of regulatory interpretation. Above note 13, 759-762.

\textsuperscript{61} It is suggested that procedural efficiency and rule-effectiveness are conceptually distinct in the sense that rules may be used at a minimum time and cost and yet fall short from delivering the intended policy objectives. Of course, it is plausible to argue that as far as regulation is concerned we can ignore this distinction. I feel, however, bound to alienate myself from this claim because it is based on an instrumental account of the institution of law and as such it misses an important feature of law: It fails to see that law is not a directive of proper conduct made by anyone but a directive of proper conduct made by our political community and as such it has an intrinsic value. The idea of law as a political institution with no intrinsic value is widely accepted among proponents of the Law and Economics school of thought as well as scholars that belong to the Critical Legal Studies movement. See, for example, R. Posner, \textit{Economic Analysis of Law} (1998) and A. Altman, \textit{Critical Legal Studies: A Liberal Critique} (1990).
enjoys a privileged position, which he is not allowed to abuse.\textsuperscript{62} Compared to a judge, the regulator may enjoy greater scope of manoeuvre when interpreting rules. However, one should not lose sight of the fact that this holds only as far as it is necessary for the prompt delivery of his public mandate and never to the effect of absolving him from the duty to act within Law.

To resume, the communicative thesis accounts for the subject matter and purpose of regulatory interpretation in a manner that appears to be unworkable and unappealing in practice. In light of this, it is suggested that it is worthwhile to explore the possibility of developing an alternative theory of regulatory interpretation. This is what I will try to do next.

5. Towards an alternative theory of regulatory interpretation: The constructive theory

In the preceding chapter, I argued that a theory of regulatory interpretation can be either \textit{communicative} either \textit{constructive} in nature.\textsuperscript{63} The distinct characteristic of the \textit{communicative thesis} is that that it resembles the method of interpretation that we deploy when we try to understand our co-discussant in the course of a conversation. In this case we allot meaning to the speaker’s utterances in light of the motives, purposes and concerns we suppose for the speaker and we report our conclusions as statements about the speaker’s intentions in saying what he did. Under this theoretical model, interpretation is seen as a means for communicating each other’s

\textsuperscript{62} P. Craig, \textit{Administrative Law} (2003), chapter 12 especially 388-393 and 400-401.

\textsuperscript{63} In fact Dworkin talks about three different kinds of interpretation; “conversational”, “constructive”, and “scientific interpretation.” Given that when we interpret a social practice like rule following, we try to make sense of it by discerning its point or purpose, “scientific interpretation” does not qualify as a candidate theory of regulatory interpretation because it is causal rather than purposive in nature. Above note 4, 49-53.
rationalities and interpreters are not concerned with finding out what the social practice of rule following “really” requires from them to do. Contrary to the communicative thesis, the *constructive thesis* is more sophisticated in its inception.\(^{64}\) It draws a sharp distinction between the speakers’ utterances and the object of interpretation in order to emphasise that, the intellectual enterprise of discerning the speakers’ beliefs about the object of interpretation is quite different from the intellectual enterprise of discerning the meaning of the object of interpretation. Under this theoretical model, the interpreters are depicted as trying to ascribe some scheme of interests or goals or principles that the practice in question can be taken to promote rather than simply understand each other’s utterances. Furthermore, they are seen as being genuinely interested in making the best sense of the object of interpretation.

I suggested Black’s analysis of the use of rules in financial regulation provides the first seeds for a theory of regulatory interpretation that is communicative in nature. I further argued that despite its plausibility and initial appeal, the communicative theory presents some difficulties and, therefore, -I proposed- that it would be worthwhile to explore the possibility of developing an alternative theory of regulatory interpretation, this time, along the lines of the constructive account of interpretation (Henceforth, I will call this *constructive thesis*).\(^{65}\) To this end, it pays to consider the idea of interpretive attitude on the basis of which Ronald Dworkin built his constructive account of interpretation in law.\(^{66}\) Dworkin explains the notion

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\(^{64}\) Above, note 4, 52-53.

\(^{65}\) Given the limited space available, I am not going to elaborate a detailed account of the alternative theoretical framework for the use of rules and its institutional implications in relation to financial regulation. My intention is simply to make the first steps towards developing a different and perhaps more promising theoretical framework for the analysis of regulatory interpretation.

\(^{66}\) Above note 4, 46-49. Dworkin’s theory of law as integrity is grounded on this constructive reading of legal interpretation. D. Litowitz, ‘Dworkin and Critical Legal Studies on Right Answers and Conceptual Holism’, 18 Legal Studies Forum (1994), 135 at 139-146. Up to this point it is useful to note that with respect to the nature of interpretation there are generally three streams of thought. Specifically one can distinguish among those commentators who offer a deterministic and mechanical account of the practice of
of interpretive attitude by using the analogy of “courtesy”, a social practice of rule following, which after some point of time starts to change. I quote from the relevant passage in *Laws Empire*:

“Imagine the following history of an invented community. Its members follow a set of rules, which they call “rules of courtesy”, on a certain of social occasions. They say, “Courtesv requires that peasants take off their hats to nobility,” for example, and they urge and accept other propositions of that sort. For a time this practice has the character of taboo; the rules are just there and are neither questioned nor varied. But then, perhaps slowly, all this changes. Everyone develops a complex “interpretive” attitude toward the rules of courtesy an attitude that has two components. The first is the assumption that the practice of courtesy does not simply exist but has value, that it serves some interest or purpose or enforces some principle—in short, that it has some point— that can be stated independently of just describing the rules that make up this practice. The second is the further assumption that the requirements of courtesy—the behavior it calls for or judgements it warrants are not necessarily or exclusively what they have always be taken to be but instead sensitive to its point, so that the strict rules must be understood or applied or extended or modified or qualified or limited by that point; it is no longer unstudied deference to a runic order. People now try to impose meaning.

The two components of the interpretive attitude are independent of one another; we can take up the first component of the attitude toward some institution without also taking up the second. We do that in the sense of games and contests. We appeal to the point of these practices in arguing about how their rules should be changed, but not (except in very limited cases) about what their rules now are; that is fixed by history and convention. Interpretation therefore plays an external role in games and contests. It is crucial to my story of courtesy, however, that the citizens of courtesy adopt the second component of the attitude as well as the first; for them interpretation decides not only why courtesy exists but also what,
properly understood, it now requires. Value and content have become entangled.”

The main insights in Dworkin’s description of the notion of interpretive attitude can be summarised in the following five points: First, the interpretive attitude engages with a complex relationship between what participants in a practice (here, courtesy) believe that this practice requires (taking off the hats) and what the practice in fact requires. For something to count as an interpretation of the practice, its must show most of the participant’s beliefs about this practice to be true. At the same time all of the participants’ individual beliefs about the practice are susceptible to revision in light of a better interpretation. What participants in the practice believe that the practice requires, and what the practice really requires are regarded as two different matters. Second, interpreting a social practice requires the interpreter to discern the point or purpose of the practice under interpretation as a whole and to use this as guidance. Third, interpretation evolves, as a result of the participants’ perpetually revised understanding of the overall value, point or purpose of the subject of interpretation. Similarly, the more widespread and radical the change in the ways participants interpret certain aspects of the practice, the more need there is for them to revise their understanding of its overall point and purpose. Fourth, as long as participants in a social practice are genuinely interested in making the best possible sense of it, there will always be a need for new and better interpretations. Fifth, as long as members of a community identify themselves as participants in a shared social practice, they are likely to have disagreements not just about the interpretation of some of its rules, but also about the overall point or purpose that the practice should be understood to have. This approach, which Ronald Dworkin calls constructive, does not

68 In the context of financial regulation, we may replace “courtesy” with “regulation” (that is controlling and guiding market conduct through the use of rules) performed by way of informal means, and the habit of “taking off the hats” with the established practice of “providing suitability letters to investors”.

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suggest that the interpreters in a particular community are allowed to make of the practice anything they would have wanted it to be, for its history constraints the available interpretations.69

It is important to stress from the outset that the notion of interpretive attitude introduces a critical dimension into interpretive practices like the use of rules in financial regulation.70 Those involved in the interpretive practice (for the sake of brevity I will call them “practitioners”) do not hold themselves responsible to a standard that is set by their individual or collective understanding of the value that justifies the interpretive practice. Rather practitioners hold themselves responsible to a standard that is set by a value, which in fact justifies the practice. This implies that the standard that governs an interpretive practice like the use of rules in financial regulation is taken to be in a crucial sense external to it. Participants accept that they may be collectively fallible, in respect of the conduct that the standard entails.71 “But while the standard in that sense is external, it is not in another. Participants are open-minded in respect of what makes their practice as it stands now to


70 Above note 29.

71 The example, I referred to earlier, where COB (z) is changed into COB (z'), can be used here as well as a case where interpreters, as a group, realise that they were collectively mistaken to think that consumer protection (the standard that underlies COB rules governing the provision of suitability letters) in certain occasions requires tied-financial advisers to act as if they were wholesale financial advisers.
require what it does.” When they correct their actual practice to conform a new and better interpretation they do so because the new interpretation better articulates the standard to which they were previously committed. Moreover, the crucial dimension that the notion of interpretive attitude introduces into interpretive practices, namely the fact that it makes space for error, entails that a disagreement of a special kind is possible to emerge. Practitioners can sensibly disagree about what is the right answer to the substantive question posed by regulatory interpretation.

The idea of interpretive attitude is a useful analytical devise. It is capable of explaining various aspects of the practice of rule-use in financial regulation, for example, what it is like to follow a rule, why rules change, why and how as well as the place and significance of evaluation in the structure of interpretive judgements. The constructive theory of regulatory interpretation draws on the insights of the interpretive attitude. It describes regulatory interpretation as a perpetual dialectical practice, whose members’ primary concern is to get the interpretation of rules right (correct interpretation).

Correct interpretation figures at the top of their priorities because they acknowledge that rules are not ordinary directives made by anyone; they are directives made by the political community. As such, they constitute part of their political history, which sets limitations on interpretive discretion and demands that these be observed.

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73 This, however, does not mean that they substitute a new and more attractive standard for the old one. Up to this point recall the earlier discussion at pages 207-208 above on the difference between interpreting and changing the object of interpretation into a different one.
74 As Stavropoulos observes, interpreters need not disagree in this special way at all times. Whether any actual disagreement is special in the sense here described depends on whether it is in fact best explained in those terms. Above note 72. See further note 29.
75 The common denominator of these aspects of rule-use is the practice of interpretation.
76 The idea of ‘correct’ (‘right’) interpretation is further clarified in Chapter Six. See particularly the discussion in pages 263-265 below.
77 Above note 4, 53.
The following example will help simplify these points. Imagine a set of COB rules, which govern the provision of suitability letters and which inter alia require from financial advisers to make sure that their customers understand the content of these letters. Everyone takes that the point of this set of rules is consumer protection. Initially no question arises whether the duties prescribed by this particular set of COB are really those the practice requires (ensuring that consumers actually comprehend the content of suitability letters even if this requires extra time and effort from the part of the financial adviser). COB rules are just there and are neither questioned nor varied. But after a while, things start to change. The financial advisers of our scenario develop a complex “interpretive attitude” towards suitability rules namely an attitude that has two components: The first is that they start to think that the provision of suitability letters does not simply exist but has value, that is, it serves some interest or purpose or enforces some principle that can be stated independently of just describing the rules that make up the practice in question. The second one is that they start to believe that what this practice requires from the financial advisers to do in terms of their conduct of business with unsophisticated investors, is not necessarily and exclusively what it has always been taken to be, but are instead sensitive

78 My example concerns regulatory interpretation at the stage of rule-following (rule-application and enforcement) and, admittedly, at first sight, it appears to be fit to inform our understanding of regulatory interpretation only in this regard. It is argued, however, that it can equally offer an insight into the project of interpretation in the course of rule-formation –namely, at that stage in which the regulator performs its policy-making and rule-making function, because here as well it is conceivable to suppose that the regulator (and virtually everyone involved in the interpretation of regulatory requirements) develops a sort of interpretive attitude similar to that described by Prof. Dworkin. The only difference is the degree of interpretive discretion allocated to the interpreters at different stages of regulatory interpretation and in accordance to their institutional role. The difference in the degree of interpretive discretion does not cancel out my claim that members of the community of interpreters can and should be seen as developing an interpretive attitude towards the object of interpretation. This is because there is always ample of scope allowing them to critically reflect on the content of regulatory requirements.

79 Consumers, regulators and virtually anyone, who qualifies to be a member in the community of interpreters, can be equally thought in place of the financial advisers of my example. Recall also that under the constructivist scheme of regulatory interpretation one belongs to the interpretive community not as a result of a shared understanding of various issues of interpretation but in light of a commitment to make the best possible sense of the object of interpretation. On this latter point I follow Professor Owen Fiss and his vision of the judiciary as a community of interpreters. Above note 13, 746.
to its point, so that the set of COB that I am talking about must be understood or applied or extended or modified or limited by that point.

Once this interpretive attitude takes hold, adherence to the practice of providing suitability letters along the lines prescribed by COB rules is no longer mechanical.\textsuperscript{80} Its assumed point acquires critical power in the sense that financial advisers begin to adhere to forms of conduct of business previously unknown or to refuse forms of conduct of business previously honoured (e.g. spending extra time to ‘educate’ their customers) claiming, for example, that true consumer protection would be better served if COB rules “stopped paternalising the interests of unsophisticated investors by requiring financial advisers to treat their customers as if the latter were incapable of assuming responsibility of the level of diligence that they show in their market transactions.” This initiates a reinterpretation of suitability rules, which alters the shape of the practice and eventually changes the content of COB governing the provision of suitability letters to the effect that financial advisers are no longer under the duty to be extra attentive to their clients’ interests.\textsuperscript{81}

The revised practice of furnishing consumers with suitability letters may encourage further interpretation and it is possible that the provision of suitability letters (and the rules governing them) changes even more

\textsuperscript{80} Were we to follow Stanley Fish on this point, we would be bound to acknowledge that the possibility of the interpreters adopting a critical attitude towards the object of interpretation is simply out of the question. As he puts it in one of his later works “there is nothing volitional in the relationship between the professional and the practices in which he is settled and therefore no sense can be given to the notion of accepting or rejecting.” S. Fish, Doing What Comes Naturally: Change, Rhetoric and the Practice of Theory in Literary and Legal Studies (1989), 75. See also, A. Goldsmith, ‘Is There Any Backbone in the Fish? Interpretive Communities, Social Criticism and Transgressive Legal Practice’, 23 Law and Social Inquiry (1998), 373, 376, 388-391, where the author argues that “the resources for criticism within professional groups are more numerous and powerful that Fish allows.” See further, R. Dworkin, ‘Pragmatism, Right Answers, and True Banality’ in M. Brit and W. Winter (eds), Pragmatism in Law and Society (1991), 380, where the he asserts that Fish’s description of interpretation is “flat and passive, robbed of the reflective, introspective, argumentative tone that is in fact essential to its character.”

\textsuperscript{81} Provided of course that in the meantime this revised interpretation has been crystallized by taking the form of a new rule.
dramatically later on. For instance, financial advisers’ views about the proper grounds of consumer protection may change from expressing the principle of equality to promoting market efficiency. The beneficiaries of consumer protection will then be only those buyers of financial products and services that are willing and able to pay in order to enjoy the privileged protection that unsophisticated investors used to benefit from, merely by virtue of their classification as ‘consumers’. Moreover, opinions may change along a different direction, about whether consumer protection requires the continuation of this practice at all. The provision of suitability letters will then figure as a trivial aspect of the way in which financial advisers conduct their business; - contrary to their predecessor- COB rules will no longer be legally binding; the interpretive attitude will languish and the practice will lapse back into the static and mechanical state in which it all began.

The fact that the community of interpreters recognise that there is a point or value in adhering to COB rules and that they attach meaning to these rules in light of this point or value suggests the evaluation is indispensable part of regulatory interpretation. This, however, does not license interpreters to make whatever they wish when interpreting rules. The Rule of Law demands that the members of the community of interpreters abstain from manipulating the content of suitability letters with the view of advancing their self-interest. Moreover the Rule of Law requires from the community

82 That is “private customer” or “retail client” according to MiFID. See also the discussion in sub-section 3.12 of Chapter One above.
84 Unlike regulatory officials, the regulatees enjoy greater freedom when asked to grasp what regulatory norms requires from them to do. This is because they are not entrusted with an institutional office (similar to that of the regulator) to which they are under the duty to remain truthful. That said the financial advisers of our example are not free to make any claim they wish about what suitability rules require from them to do but only claims that can be licensed and encouraged by the history of this practice. In short the difference between the regulator’s freedom when interpreting a regulatory requirement and the regulatee’s freedom when interpreting regulatory requirement is only a matter of degree. See also the discussion in
of interpreters to never stop checking out the interpretation that rules receive, identify mistakes and remedy them appropriately. As long as interpreters are genuinely interested in making the best sense of COB rules, there will always be a need for better interpretation.

Frequently the perpetual attempt to get the meaning of rules right will give rise to multiple readings and, as a result, trigger disagreement and a laborious debate about the proper interpretation of rules.\textsuperscript{85} This, however, is not a sign of weakness (a pathological feature that inevitably crops up due to the linguistic nature of rules). Rather it is an indication of a healthy interpretive process, for it is this disagreement that brings into the surface ambiguities and other problems of interpretation and it is through this painstaking process that those involved in the interpretation of rules can hope to come up with better interpretations.\textsuperscript{86}

This brings me to a further point I wish to make this time in connection to the notion of rule-effectiveness and how it shapes policy choices with respect to the use of rules. Contrary to the communicative thesis, which connects the effective-use of rules with considerations of procedural efficiency, the constructive thesis proposes a different understanding of this concept. On the constructive view, rule-effectiveness captures the fact that interpreters work towards discerning the true meaning of rules instead of simply making clarifications or trying to cultivate a common understanding of regulatory requirements. In practical terms, this implies that for the proponent of the constructive reading of regulatory interpretation a sound

\textsuperscript{85} J. B. White, above note 3, 444.

\textsuperscript{86} It follows that the terms “over-inclusiveness”, “under-inclusiveness” and “legal indeterminacy” are not of much help in making sense of the workings and purpose of regulatory interpretation. At best they offer a distorted account of regulatory interpretation. This happens partly because these terms derive from a narrow and deeply problematic conceptualisation of the notion of intention in interpretation. On that see the earlier discussion on the complex interaction between intentions and beliefs at pages 211-213 above.
policy of rule-use should not just aim at certainty and predictability by way of promoting some sort of interpretive convergence. Its aim should be the far more challenging objective of encouraging a special attitude towards the subject of interpretation—an attitude that manifests a collective commitment to make the best possible sense of it. Accordingly, whereas for the communicative theory failure to make effective use of rules is failure of communication, for the constructive theory failure to use rules effectively amounts to failure to unearth the true meaning of regulatory requirements.87

The above analysis suffices to make plain the differences between the constructive and the communicative thesis of regulatory interpretation. According to the communicative thesis, the subject matter of interpretation is the interpreters’ utterances. According to the constructive thesis, the subject matter of interpretation is the text that embodies the rule in question. On the communicative view, the purpose of interpretation in the regulatory context is to address failure of communication by working towards some sort of interpretive convergence. By contrast for the constructive account, the purpose of regulatory interpretation is correct interpretation. The constructive account is attentive to the special interpretive attitude that practitioners adopt when interpreting rules. Contrary to the communicative thesis, the constructive thesis depicts regulatory interpretation as practice in which interpreters treat the subject matter of interpretation as an object that exists independently from what they believe or intend it to be. Accordingly, “what the rule means” is not whatever the community of interpreters wants it to be but an interpretation

87 In terms of institutional architecture this would involve a far more active role for the judiciary than the one envisaged in Rules and Regulators (there it is argued that the regulatory system should be closed-off from external judicial interference. Above note 48, Rules and Regulators (1997), 35-36). It is suggested that the establishment of the Financial Services and Market Tribunal, the institutionalisation of expert legal advice within the bureaucratic organisation of the regulatory Authority and the availability of judicial review constitute firm manifestations that there is a clear trend towards strengthening the role of the judiciary, which can be explained in light of a change in perception of the notion of rule-effectiveness.
that best justifies the point or function of the rule in question. The communicative account misses this point and as a result offers an impoverished depiction of the practice of interpretation.

6. Conclusion

The aim of this chapter was twofold: On the one hand, to show that despite its initial appeal the communicative theory of regulatory interpretation is not free from problems and, on the other hand, to develop a position thesis for the possibility of an alternative theory of regulatory interpretation (the constructive theory of regulatory interpretation).

The discussion started with the observation that the underlying assumptions of the communicative theory touch upon very controversial issues in relation to interpretation, for example, the point of interpretation, the difference between interpreting and changing the object of interpretation into a different one, the limits of interpretive discretion, the nature of arguments about interpretation, the difference between beliefs and intentions etc. Given the perplexity of these issues, it was suggested that before assessing the robustness of the communicative thesis it would be essential to gain a deeper understanding of the practice of interpretation in general. To this effect I compared regulatory interpretation as species of legal interpretation with interpretation in literature.

The comparative analysis revealed that literary interpretation and regulatory interpretation are identical in a number of fundamental respects. In both domains we witness the institutionalisation of authoritative interpretation and both cases involve the interpretation of text, which – although ‘man-made’- is treated as an entity that stands independently from its author or
interpreter as the case may be. Furthermore, a genuine commitment to make the subject of interpretation the best it can be is present in both literary and regulatory interpretation. Frequently, this finds expression in rational disagreement about matters of fact as well as about matters of value.

The application of all these insights to regulatory interpretation revealed a picture of interpretation that is different from the communicative account. Specifically, the analysis made plain that the subject matter of interpretation is not the interpreters’ utterances as the communicative thesis assumes, but the rule itself. Similarly, the point of interpretation is not to attain consensus (interpretive convergence) but to make the rule in question the best it can be, paying attention to a number of considerations, which work as constraints over one’s interpretive discretion. Moreover, the discussion on the practice of interpretation divulged that interpreters develop an idiosyncratic interpretive attitude towards the subject matter of interpretation. They treat it as an object that stands independently of their intentions and beliefs in order to allow space for error and correction through rational criticism and deliberation. More importantly though, it showed that the communicative thesis offers a theoretical framework for the rationalisation of regulatory interpretation, that is neither workable nor appealing in practice.

In light of these difficulties, an alternative account of regulatory interpretation was explored. Borrowing from Professor Dworkin’s analysis of the practice of interpretation in law and in particular the notion of interpretive attitude, I sketched a theoretical account of regulatory interpretation that describes this practice—not simply as an occasion for improving communication among the members of the regulatory
community but- as a dialectical practice whose ultimate objective is to meet
the demand for new and better interpretations.

Now that the two theoretical accounts of regulatory interpretation have
been fleshed out it is time to spell out how they inform our understanding
of the grounds for the interpretive shift in the policy of rule-use in financial
regulation. Specifically, the communicative account of regulatory
interpretation and its constructive counter-part offer two alternative
explanations of the reasons for this policy development. According to the
communicative thesis, the interpretive shift is justified as an attempt to
secure the effective use of rules by remedying failure of communication
between the regulator and the regulated firms. On this account the rationale
for the interpretive shift in regulatory interpretation draws on the need to
combat information asymmetries and interpretive divergence to the extent
in which they impede effective regulation. According to the constructive
thesis, the move towards an interpretation-centric policy of rule-use can be
better explained as an initiative whose purpose is to facilitate the wider
regulatory community in meeting the demand for new and better
interpretations by duly identifying and remedying interpretive mistakes
before and where possible in preclusion of judicial interference.
Significantly, on the constructive view, the interpretive shift is not justified
in terms of informational discrepancies and interpretive divergence. Rather,
its rationale is grounded on an idea of regulatory interpretation as the
ultimate dialectical practice that commands and encourages the participants
of the wider regulatory community to work out the public standards
(“principles”) that govern their inter-relations.

Which of the two accounts of the interpretive shift in financial regulation is
preferable? The inherent weaknesses of the communicative thesis were just
discussed. However, it would be too early to subscribe to the constructive thesis. This as well is subject to a range of objections. Of particular interest is the criticism that the constructive thesis must be abandoned either because—contrary to what it holds—there is no right answers to questions of interpretation or because it is not compatible with considerations of procedural efficiency. In the next chapter, the attempt will be made to reinforce the case for a constructive theory of regulatory interpretation and, consequently, a constructivist view of the interpretive shift of regulatory interpretation by defending the constructive thesis against this objection.
CHAPTER SIX

Some Objections to the Constructive Thesis

1. Introduction

In light of the meagreness of the communicative account of regulatory interpretation, chapter Five concluded with a position thesis for the formation of an alternative theoretical description of regulatory interpretation, the constructive account as it was coined. Many commentators would feel unease with the constructive thesis. The constructivist describes the use of rules in the regulatory context in light of the interpretive attitude, which entails that interpreters make evaluative judgements in their attempt to describe a particular practice in its “best light.” Moreover, it assumes that “there is a truth of the matter” in questions of interpretation and that interpreters, insofar as they are serious in what they are doing, are committed to the task of finding out what regulatory requirements truly require from them to do. An issue of concern therefore is how to decide what values describe a particular practice in its “best light.” We seem to lack the ability to decide this matter in an objective or rational manner. Values are not out there in the world for us to observe. Besides people differ considerably in what they value and how they value it depending on their upbringing, their cultural background, their interests and personal aspirations. Would it be naïve –if not an ultimate sign of dogmatism- to insist that only one holds the truth and that the rest is
wrong? Would a blind persistence to right answers not bring the regulatory process into a deadlock?

This objection takes issue with a claim that stands at the heart of the constructive reading of regulatory interpretation, namely the assertion that regulatory interpretation should be understood as an argumentative practice in pursuit of “rightness”. It contends that there would be a point to worry about getting things right, if there were indeed such a thing as objectively true or false answers to questions of interpretation. But there aren’t. All there is perhaps is different answers and in light of this diversity we need to be wise and modest enough to keep our minds open and ready to recognise the rationalities of others. If we really care to secure that regulation remains a fruitful and worthwhile project, consensus (rather the pursuit of right answers) seems to be the only realistic way we can hope to make this happen. On that view, the constructive thesis fails. As long as it endorses the quite implausible idea of objectivity in questions of interpretation, it introduces a dialectical ethos that is dogmatic and indoctrinating. Furthermore, it traps the interpretive process to the chase of an unrealistic agenda. By contrast the communicative thesis is by far more promising. It is based on a pragmatic depiction of regulatory interpretation, it regards interpretive convergence as the ultimate objective of the project of interpretation and it is attentive to the fact that considerations of procedural efficiency are paramount when it comes to the day-to-day regulation of financial markets.

This is a serious attack to the constructive thesis. It is essential therefore to address this challenge as fully as possible. Below I will try to explain why an attack along the lines of the claim that there are no right answers to questions of interpretation is bound to fail by locating the frequent
theoretical misgivings about the truth of evaluative claims within the broader philosophical trend of value scepticism.

2. The philosophical foundations of the criticism: Value-scepticism

The criticism to the constructive thesis that I briefly sketched in the introduction is informed by what has become known in academia as *value scepticism*, the influential stream of thought that refutes the idea of objective truth in evaluative judgements (moral, aesthetic, interpretive etc).\(^1\) Value scepticism comes in two forms. It can be either internal or external.\(^2\) The following example will help illustrating the difference between internal and external scepticism. Suppose that two sceptics happen to overhear you and me disagreeing about an art review in the newspaper, which claims that El Greco’s art of painting is superior to Picasso’s. One of them says: “These people are both mistaken. There is no point to compare El Greco and Picasso. Artistic merit should be assessed in terms of the painter’s capacity to capture light and, therefore, Rembrandt is the best of all times!” The other says: “No my friend. You are mistaken for the same reason as they are. By claiming that their views are *false*, you have already accepted that their evaluative judgements admit of truth-value. If you want to maintain your sceptic stance, all you have to do is to say that your view simply differs

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1 Scepticism has been influential within academic philosophy since a long time ago and it has recently revived in legal scholarship (but also in other disciplines) under the names of “post-modernism,” “anti-foundationalism” or “neo-pragmatism.” *Value scepticism* should not be confused with the general all-encompassing version of scepticism, which attacks the very idea of objective truth about anything. However, adherents of both versions claim that it is possible to stand outside a whole body of belief and to judge it as a whole from premises that are independent to it. Therefore, Ronald Dworkin calls them “archimedean.” My concern is with the selective version of scepticism. R. Dworkin, ‘Objectivity and Truth: You’d Better Believe It’, 25(2) *Philosophy and Public Affairs* (1996), 87, 87-89. For a detailed analysis of philosophical scepticism and its various forms see, P. Klein, ‘Scepticism’ in *Stanford Encyclopedia of Philosophy* (2005)[www.plato.stanford.edu/entries/scepticism]; O. Bueno, “Davidson and Scepticism: How Not to Respond to the Sceptic”, 9(1-2) *Principia* (2005), 1-18; B. Stroud, *The Significance of Philosophical Scepticism* (2003).

from theirs, and perhaps add that you have that view because you have always admired Dutch art, hate Spanish artists especially the manierist and cubist ones’ etc. What you definitely cannot do is say that your view is objectively true and that theirs is false.”

The first sceptic is an *internal sceptic.*³ His claim that you and I are mistaken because Rembrandt is the best painter is internal because it denies some group of positive claims (“that Picasso is the best painter” or “that El Greco is the best painter” and justifies that denial by endorsing a different positive aesthetic claim (“Rembrandt is the best painter”). The internal sceptic holds a substantive position, which has direct implications for action. For instance if someone is sceptical about the artistic merit of Picasso’s painting because he things that this should be measured against the painter’s capacity to capture the interplay between light and colour, he cannot consistently acknowledge artistic merit in the work of Braque or other cubists.

The second sceptic is an *external sceptic.*⁴ His claim is external because it does not rest on any positive aesthetic judgement and it does not take sides in substantive evaluative controversies.⁵ External scepticism is not directed to substantive aesthetic convictions. It is directed to second-order opinions about such convictions. An external sceptic may agree with a number of other art lovers that Rembrandt is the greatest artist. He keeps saying however that this is only a personal view because there isn’t such a thing as artistic merit or value out there in the world. He holds that that we have projected aesthetic quality onto reality. It is our emotions and social conventions that make a school of painting look of higher quality to another.

³ R. Dworkin, 89-92, above note 1; and *Law’s Empire,* note 2, 78-79.
⁴ R. Dworkin, above note 1, 92-93; and *Law’s Empire,* note 2, 79-80.
⁵ Dworkin calls the first characteristic “austerity” and the second “neutrality”. R. Dworkin, above note 1, 93-94.
Internal sceptics like the first speaker need to appeal to the concept of objective evaluative truth as much as their rivals. Although they question the objectivists’ substantive claims about what is the case, they do not question the objectivists’ claim that the substantive question admits of (objectively) true and false answers. By contrast external sceptics consider themselves wholly absolved from the task of disputing the truth of anyone’s evaluative claims. They simply insist that we should guard against the illusion of thinking that our preferences or beliefs are anything more than just our preferences and beliefs. To conclude, external sceptics prompt us to argue for, defend, promote or revise our evaluative judgements and to reject, criticise or accept those of others; but they warn us that we are not entitled to claim objective truth or falsity for either.

A crucial feature of internal scepticism is that its advocates cannot be sceptic all the way down. They can’t because they build their scepticism on some affirmative evaluative position (aesthetic, moral etc). If they claimed that no aesthetic judgement of any kind could be true, they would condemn their own theory because they would negate the positive evaluative judgements in which it is grounded. Therefore, internal scepticism does not pose a serious threat to the claim that there are no (objectively) right answers to questions of interpretation. By contrast, external scepticism does. It bears with it the promise that it is possible to criticise a whole scheme of beliefs about values (aesthetic in our example) from a perspective that is external and totally independent from that scheme of beliefs. Given that internal scepticism poses a trivial challenge to the constructive thesis from now onwards I will concentrate on the external version of value scepticism.

The virtues of external scepticism are particularly evident nowadays in light of the immense culture diversity that resides in secular western societies.
This is even more so, once our attention turns to the public sphere where debates are more likely to be passionate and more difficult to resolve.\(^6\) In this context, many people feel that if one’s views find great opposition by the majority then it is arrogant for that person to insist that he is the one who holds the sole truth and that all those who disagree with him are in error. External scepticism is an appealing doctrine because it allows people to be culturally relative and modest and at the same time embrace their morality perhaps even more enthusiastically then before. Indeed, external scepticism promises to offer the best of both worlds because it supposedly makes possible for members of a community that are divided by disagreement to revise their views not about the substance of their convictions but about their status. In this fashion they “can … fight… for their beliefs as they ever were, but now with a difference. They can have their moral convictions and lose them too.”\(^7\) To cut a long argument short, external scepticism is appealing because it is “agreeably ecumenical”.\(^8\) On the one hand, it engulfs all those ideals that make a sound conversational ethos (openness, equal respect to each other’s rationalities and deliberation to mention a few) and which command equality in front the law\(^9\) and, on the other hand, it envisages public dialogue as a consensus-building project. The latter is particularly valuable as it is thought to create favourable conditions

\(^6\) Typical examples in the literature are debates about abortion, euthanasia, capital punishment and freedom of expression. However, one can easily borrow examples from the financial services terrain, as, for instance, the current discussion on what should be the role of the Bank of England in times of cash shortage in the banking system especially where consumer interests are affected. For instance, in connection to the recent woes in the housing market where many consumers have been facing a serious risk to lose their homes after a number of British banks had gradually tighten up lending, one might argue that “it is unfair for mortgage buyers to suffer the consequences of events that were beyond their control.” FSA, ‘Northern Rock’ (21 January 2008) FSA/PN/005/2008; Marvin King, Tumult in Financial Markets: What Can Central Banks Do? (12 September 2007), paper submitted to the Treasury Committee by the Governor of the Bank of England [www.bankofengland.co.uk/publications/northernrock/index.htm].

\(^7\) R. Dworkin, above note 1, 94. Richard Rorty calls this “irony”. See generally, R. Rorty, Contingency, Irony and Solidarity (1989).

\(^8\) R. Dworkin, above note 1, 93.

\(^9\) Equality is here as a residual principle, which requires all political and legal institutions to acknowledge that, “…all members of a community equally have the right to respectful consideration…” J. Finnis, Natural Law and Natural Rights (2003), 173. I will return to this point later on when I will be discussing the compatibility of the constructive account of regulatory interpretation with considerations of procedural efficiency.
for the realisation of other desirable state of affairs including stability, certainty and predictability and overall procedural efficiency.\textsuperscript{10}

It is true that none can seriously disagree with the normative aspect of the sceptic’s thesis; on the one hand, his claim that we should respect other people’s views, that we should be open to them and that we should always be willing upon reflection to revise our ideas and beliefs and, on the other hand, his concern with the efficiency of public institutions (although an issue here is whether the communicative thesis is the only theoretical framework that is eligible to bring these state of affairs into fruition). However, the same is not true with respect to the metaphysical aspect of his argument namely, his claim that evaluative judgements cannot be true or false and his concomitant conviction that the constructive thesis cannot accommodate our reasoned concern with procedural efficiency as long as it bounds the interpreters to futile chase of right answers.

For example, when I argue that taxation is theft and, therefore, I consider it to be “objectively” or “really” wrong, I genuinely believe this to be the case. If you replied that I say so because of my wealthy background I would think that this is beside the point, because I know that my aversion is grounded on my belief that it is not fair –if I do not wish to- to share with others the fruits of my own labour.\textsuperscript{11} Furthermore, if you insisted that this is simply my opinion and that there is no truth of the matter about whether taxation is fair or unfair, right or wrong, I would consider this to be bizarre because I

\textsuperscript{10} It is quite common to use the term procedural efficiency in order to establish some sort of affiliation with the economic analysis of regulation. For the purposes of this chapter, I do not mean to subscribe to any of the troubled definitions of economic efficiency however. I use this term loosely to highlight the basic idea that consequences matter and, as a result, regulation must not waste the community’s scarce resources by utilising inefficient methods. Its success must be measured inter alia against its effectiveness and its fitness for purpose. Above note 1, 111-118. On the various notions of efficiency see D. M., Hausman and M. S. McPherson, Economic Analysis and Moral Philosophy (2003), ch.7; R. Posner, Economic Analysis of Law (1998), 13; and M. Adler and E. Posner, ‘Rethinking Cost-Benefit Analysis’, 109 Yale Law Journal 165 at 199.

\textsuperscript{11} This thought-provoking idea constitutes the nucleus of a libertarian conception of justice. See generally, R. Nozick, Anarchy State and Utopia (1974).
feel that I am capable to reach credible evaluative judgements and I believe the same for others who may disagree with me. I have considerable evidence in my own experience—as I think you have in yours—of people’s capacity to make evaluative judgements that bring conviction, that are mainly durable, and amenable to the judgements of a great many others. My experience also suggests that my capacity to make evaluative judgements is not infallible. I am open to criticism and all I need to revise my opinion is reasons that I will have to weight in favour or against my initial belief and which will shape my final conclusions. Moreover, if you sarcastically asked if I had seen, felt or touch any values lately, I would have no hesitation to answer no and, further, explain that I do not use the words “objectively” or “really” literally but rather emphatically in order to stress that if my claim is true, then it is, even if no-one (not even me!) thought it to be so. All I am trying to do is to make room for mistake and the only way to do so is by drawing a distinction between what I believe to be the case and what the case is. Finally, if you complained that this discussion leads no-where, I would feel reluctant to share your disappointment and I would reassure you that conducting vivid debates neither entails the collapse of the institutional framework that facilitates this on-going dialogue nor is it a sign of weakness and decay, for it is only through contestation and argumentation that we can hope to advance our ability to address present and future challenges.12

With all these untidy thoughts I want to suggest that the case for value scepticism is not at all self-evident. Below, I will take issue with both the normative and the metaphysical aspect of value scepticism starting from the second first.13 In relation to the metaphysical limb of value scepticism my

13 My preoccupation with the metaphysical limb of external scepticism might take some readers by surprise given the affinities of my thesis with interpretivism, a school of thought that doubts the relevance of metaphysics to practical concerns. I felt, however compelled to discuss at some length this aspect of the criticism for mainly two reasons. First, due to its great influence to the mainstream literature on regulation, and second because the interpretivists’ aversion to metaphysics is not shared by all. On that point see, M.
argument will be that value scepticism is a flawed philosophical doctrine. With respect to its normative aspect I will try to explain why –contrary to what the critique believes- adherence to the constructive account of regulatory interpretation neither opens the way to an unsound conversational ethos nor is incompatible with considerations of procedural efficiency.

3. The metaphysical aspect of value scepticism: A critical appraisal

3.1. Introduction

As a metaphysical doctrine, external scepticism claims to be “neutral” and/or “austere”. It is neutral in the sense that it is capable of questioning a whole scheme of beliefs about value without challenging the substantive evaluative claim. It is austere in the sense that it pledges to construct its criticism wholly independently of any positive evaluative claim or assumption. “Neutrality” and “austerity” are deeply problematic for reasons I explain below.

3.2. Neutrality

Moore, ‘The Interpretive Turn in Modern Theory: A Turn for the Worse?’, 41 Stanford Law Review (1988-89), 871-957. Martin Heidegger was the first to argue that the entire metaphysical debate since Plato and Aristotle must be left behind. M. Heidegger, Sein und Zeit (1926) translated by J. Macquarrie and E. Robinson as Being and Time (1962).

14 R. Dworkin, above note 1.
Those advocating the neutral version of external scepticism do not cast doubt to substantive value judgements. Their scepticism is directed to second-order opinions about such judgements. With other words they are sceptical not about personal beliefs concerning matters of value (aesthetic, moral etc) but on what we might call the “self-value” view of the status of these beliefs.\textsuperscript{15} For example, an external sceptic, who subscribes to neutrality, might agree with me that taxation is wrong or unfair act –he would only deny that taxation, as an institution is truly (really or objectively) wrong. He maintains that the wrongness of taxation is not out there in the real world. It is projected onto reality due to the feelings of distress that are caused inside our hearts even by the thought of being deprived of part of the fruits of our labour on regular basis and irrespective of whether we consent to this practice or not. Events and actions are not in themselves right or wrong, good or bad. Rather, they are made right or wrong, good or bad as a result of our emotions, projects or conventions.

How can we explain the fact that external scepticism of that form is not directed to substantive moral convictions but only to second order opinions about such convictions? Consider the following three moral statements.\textsuperscript{16} “Taxation is wrong.” “It is true that taxation is wrong.” “It is objectively (or really) true that taxation is wrong”. For the sake of convenience, I will follow Ronald Dworkin and call the first statement I- (for internal) proposition, and the second and third E- (for external) propositions.\textsuperscript{17} According to the proponents of the neutral version of external scepticism, there is a logical space between I- and E-propositions.\textsuperscript{18} Whereas I-

\textsuperscript{15} R. Dworkin, above note 1, 92.
\textsuperscript{16} Recall that value scepticism does not deny that propositions like “Every month £800 are deducted from my salary for tax purposes” admit of objective truth because the truth of this statement can be empirically assessed.
\textsuperscript{17} R. Dworkin, above note 1, 92-93.
\textsuperscript{18} An external sceptic need not be both neutral and austere. For those sceptics who endorse austerity but not neutrality I-propositions are as much subjective and biased as E-propositions. See below the discussion of John Mackie’s scepticism at pages 254 to 257 below.
propositions are part of substantive morality, E-propositions are not and, therefore, they are susceptible to criticism. They suppose that there is something altogether distinct from the ordinary substantive moral claims we all make, so that we may accept the sceptics’ arguments and at the same time continue to judge and act, in the moral dimension, as we did before. Richard Rorty, who is one of the most celebrated American exponents of wholesale external scepticism, explains why E-propositions are altogether distinct from I-propositions by distinguishing between two levels of thought or discourse.\textsuperscript{19} To cite from the relevant passage:

“[O]ne of the obvious truths about mountains is that they were here before we talked about them. If you do not believe that you probably do not know how to play the language-games which employ the word “mountain”. But the utility of those language games has nothing to do with the question of whether Reality as It Is In Itself, apart from the way it is handy for human beings to describe it, has mountains in it.”\textsuperscript{20}

As Dworkin comments, Rorty imagines two levels of discourse.\textsuperscript{21} “The first is the ordinary level at which you and I live: at that level mountains exist, existed before there were people, will exist presumably, after there are people and would have existed, presumably, even if there had never been people.” The second level is a philosophical level. At that level the question “do mountains exist?” does not arise. Instead a different question can emerge: “whether Reality as It Is In Itself contains mountains.” Rorty believes that it is at this second level that the dispute should be located. A common criticism to Rorty’s position is that none of this makes sense, unless the proposition that mountains exist can be given a different meaning  

\textsuperscript{19} The wholesale archimedean scepticism refutes the idea of truth about anything, either this relates to statements about matters of fact (“descriptive claims”) either this relates to statements about matters of value (“evaluative claims”). R. Dworkin, above note 1, 88.


\textsuperscript{21} R. Dworkin, above note 1, 96.
from the proposition that mountains are part of Reality as It Is In Itself.\textsuperscript{22} Rorty asserts that these two propositions do not share the same meaning. He further assumes that the first proposition (I-proposition) is internal to our vocabulary of geology, whereas the second (E-proposition) is external to it. However, he remains silent as to what is it exactly that makes these two propositions different.

Given the artificiality of Rorty’s distinction between levels of thought or discourse, Dworkin proposes that we would be better off if we abandoned it altogether and opted instead for a more natural reading of I- and E-propositions, where the latter reveal themselves as restatements or clarifications of the former.\textsuperscript{23} To illustrate this point consider the following example. Suppose that I am speaking at some length about taxation.\textsuperscript{24} I begin by saying “Taxation is wrong.” This is a first order I-proposition about morality. Then I add a variety of other propositions that fall within the category of E-propositions and constitute what we could call my “further claims”. I also claim, that “What I said about taxation was not just an expression of my emotions when I receive my payslip with the tax deductions each month. Similarly, my opinion is not informative of other people’s emotions or reactions. My opinion is \textit{true}. It is \textit{true} quite apart from any one’s emotions or preferences and quite apart from me intending it to be true or not. My view is universal and absolute and describes things (that “taxation is wrong”) as they \textit{really} are. They are part of the fabric of the universe. They are reports about how things really are out there in an independent subsisting realm of the world.” Can we find a plausible reading of my “further claims” that shows them to be positive moral judgements themselves –either restatements or clarifications of the original first order I-

\textsuperscript{22} R. Dworkin, above note 1, 96.
\textsuperscript{23} Above, \textit{96-99}.
\textsuperscript{24} Dworkin uses a similar example in relation to abortion. R. Dworkin, above note 1, 97-99.
propositions, or additional moral claims that explicate those I-propositions? If yes, then any scepticism about them must be morally biased rather then neutral. It is not difficult to answer this question in the affirmative. The most natural reading of the further claims shows them to be nothing but clarifications or emphatic or metaphorical restatements of the first I-proposition that “taxation is wrong”.

Indeed, if someone thinks that taxation is wrong he might well say that, “It is just true that taxation is wrong.” Similarly, if someone chooses in addition to use the adverbs “objectively” and “really”, he does so in order to clarify the content of his opinion. His intention is to distinguish his opinion so qualified from other opinions that he regards them as “subjective” in the sense that they refer to something that is just a matter of taste. For example, if someone declares that tennis is a “bad” or “worthless” game, he may well concede, on reflection, that his distaste of tennis is entirely “subjective,” that he does not regard the game as in any “objective” sense less worthwhile than games he prefers to watch. It follows that, in ordinary discourse, the claim that taxation is objectively wrong seems equivalent to any of the “further claims” I made earlier. That read is just another way of emphasising the content of the original moral claim, of stressing for once again that taxation is just plain wrong, not wrong only because people think it is.

Furthermore, when I say that I know that taxation is wrong, it is reasonable to expect that I will be understood as claiming that I have compelling reasons for believing that taxation is wrong. So read, my further claim turns out to be an I-proposition as well. It implies that insofar as taxation involves the State’s deliberate exercise of coercion against my (or indeed any one’s) free will not to share the fruits of my (one’s) own labour with others or only

25 R. Dworkin, above note 1, 97-99; and Law’s Empire, note 2, 80-83.
26 R. Dworkin, above note 1, 99.
with those I choose to, we have compelling reasons for condemning this practice. The further claim that “it is universally or absolutely true that taxation is wrong” can also be understood as a restatement of my original moral claim. It clarifies its scope by making it plain that in my view taxation is wrong for everyone, regardless of one’s social, racial or cultural background. Finally, my flamboyant assertions about moral “facts” being “out there” in an “independent” realm need not be read literally simply because these are not things that people might actually say. Rather, they can make sufficient sense, as metaphorical ways of repeating my earlier remarks about the moral quality of taxation.

3.3. Austerity

So far it has been argued that the first metaphysical component of external scepticism –its supposed neutrality- collapses. An external sceptic does not necessarily claim to be neutral, however. He may endorse a purely austere form of scepticism arguing that there is no logical space between first and second order propositions and that, as a result, first order propositions are biased and subjective as well. Take the example of John Mackie, one of the most celebrated proponents of value scepticism with respect to morality. In his book *Ethics: Inventing Right and Wrong*, he contends inter alia that neither first order nor second order ethical views admit of objective truth because radical differences between moral judgements make it difficult to treat those judgements as apprehensions of objective truths. Mackie relied on two

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27 It is not the first time that the question of objectivity in interpretation is discussed. In chapter Four, I touched upon this theme to the extent in which –I felt- it was necessary in order to elucidate a number of key issues that crop up with respect to interpretation in general as, for example, the subject matter of interpretation, the difference between interpreting and changing the object of interpretation into something else, the presence (if any) and function of interpretive constraints etc. This time I return to this topic and consider it in more detail in order to explain why value scepticism offers a lame support to the objections to the constructive thesis.
arguments to support his view: the argument from “relativity” and the argument from “queerness”.

According to the argument from moral relativity or diversity, the fact that people disagree so much about morality, from time to time and from place to place and, even within particular cultures, shows that no moral claim can be true. At first sight, the intuition underlying this claim seems to be simple and compelling. “If others, who seem to be just as intelligent as I am, disagree with me, why should I be so confident that I am right and others are wrong?” Yet, after a second thought, it seems strange to jump to the conclusion that as a result of radical disagreement there is no truth of the matter when it comes to moral claims. “We would not count the popularity of our moral opinions as evidence for their truth, why should we count their controversiality as evidence against it?” Furthermore, there is an additional problem with the argument from relativity. Whether diversity in given intellectual domain has sceptical implications depends on whether “the best account of the content of this domain explains why it should.” The best account of scientific thought does explain when and why disagreement in scientific judgement is suspicious. If thousands of people claimed that they have seen green horses but disagreed vividly about their size and shade of colour, scientists would discount their evidence because if there really were green horses and people had seen them, there would have been more uniform reports about their properties. Things are different in the so-called soft intellectual domains (e.g., morality). Since moral opinions are not caused by moral facts, we do not conclude from the diversity of moral views that no positive moral claim is true.

28 R. Dworkin, above note 1 at 113.
29 Above, 113-114.
30 Above.
Mackie’s second argument—the argument from queerness contemplates the argument from relativity. This time, however, the focus of attention turns to the peculiar ontology of values. As he puts it “If there were objective values, then they would be entities or qualities or relations of a very strange sort, utterly different from everything else in the universe. Correspondingly, if we were aware of them, it would have to be by some special faculty or moral perception or intuition, utterly different from our ordinary ways of knowing everything else. When we ask the awkward question, how we can be aware of the truth..., none of our ordinary accounts of sensory perception or introspection or the framing and confirming of explanatory hypotheses or inference or logical construction or conceptual analysis, or any combination of these, will provide as satisfactory answer; ‘a special sort of intuition’ is a lame answer, but is the one to which the clear-headed objectivist is compelled to resort.”

Advocates of austere scepticism like John Mackie maintain that it makes no sense to suppose that acts or events or institutions have moral properties unless we have some plausible account of how we—as human beings—could be “in touch with” or aware of such properties. On that view, the only way to resolve disagreements about what is good, right, beautiful is to posit the existence of distinct and real entities called “values”, a bear appeal to which would settle the dispute in favour of one or the other competing claim. Some philosophers have attempted to confront the sceptics’ ontological argument by propounding that values exist as real features of the world. John McDowell, for instance, has maintained that there is no reason why we

31 Professor Mackie makes clear from the outset that his position is essentially an ontological thesis. As he points out, “…what I have called moral scepticism is an ontological thesis, not a linguistic or conceptual one.” J. Mackie, Ethics: Inventing Right and Wrong (1977), 18.
32 Above, 38–39.
should treat our perception of values differently from our perception of different aspects of the world, such as the colour and texture of objects.\footnote{J. McDowell, ‘Values and Secondary Qualities’ in T. Honderich (ed.), \textit{Morality and Objectivity} (1985).}

It seems to me, however, that this response is totally unconvincing. To the extent it relies on the supposition that the truth or falsity of evaluative judgements depend on whether values are real features of the world, whose existence affects our faculties of perception in one way or another, it demands from us to subscribe to a counterintuitive ontology. Indeed, if we were ever asked whether we have seen, heard, touched or felt any values lately, we would probably find the question absurd, for when we are making evaluative judgements we are not claiming that values exist \textit{anywhere} or in \textit{anything}. Therefore, it is suggested that a more convincing line of argument is the one provided by Donald Davidson.

Davidson proposes that truth need not be thought of in ontological terms.\footnote{D. Davidson, ‘A Coherence Theory of Truth and Knowledge’, chapter 10 in \textit{Subjective, Intersubjective Objective} (2001), 137-157.} Starting from the observation that the existence of thought is perhaps the only thing that we can be sure of,\footnote{D. Davidson, ‘The Problem of Objectivity’, Essay 1 in \textit{Problems of Rationality} (2004), 3, 6.} Davidson demonstrates that we cannot have a belief without understanding that this belief may be falsified by the facts. Similarly we cannot attribute any content to our beliefs without having a basic grasp of what it would take for them to be true. For example, to make sense of my belief that I have three chocolate bars in my bag, I must have a grasp of what would make that belief true, namely the presence of three chocolate bars inside my bag (or false, namely the presence of less then three chocolate bars or none). Significantly, this condition holds even if I have no way of making \textit{sure} that my belief is true. The statement “Life will never be found in another planet” will be perfectly intelligible to any audience even though there is no possibility that members of that audience
will be able to confirm whether the statement is true or not. The audience understands this sentence well enough insofar as it has a grasp of what would need to be the case for the statement to be true.

The same point applies to our possession and use of concepts. To have a concept is to be able to classify things under it, i.e. to have criteria that distinguish things that fall within the concept from things that fall outside it. Moreover, awareness of the possibility of mistake in the course of its application is an essential part of having a concept (e.g. I believed that I saw a yellow object. But the object was actually orange, so my application of the concept seemed correct but was not.). In all, to have concepts and beliefs, one must be able to identify the conditions that would make them (or for concepts their application) true. If thought exists, then so does the idea of truth, which stands independently from the content of one's beliefs about the world.36

Davidson further argues that identifying the truth conditions of any belief presupposes that I have a grasp of a whole web of other concepts and beliefs (holism). My believing that there are three chocolate bars in my bag requires that I have a grasp of the concepts of “chocolate bar” and “bag” as well as of basic arithmetic and orientation. Given the flexibility of our use of language and sentence construction, this entails that there is no definite amount of beliefs that I must assume to be true in order to identify the truth conditions of a given belief.37 Rather, to identify the truth conditions for any one of my beliefs I must always rely on the assumption that my beliefs as a whole are (objectively) true.38 It is only against such a rich background of

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37 For example, consider the range of beliefs that I would need to assume as true in order to make sense of my belief that ‘someone took a picture of me while I was watching a star falling from the sky’.
38 D. Davidson, ‘A Coherence Theory of True and Knowledge’, Essay 10 in Subjective, Intersubjective Objective (2001) 137, 138-40. Davidson has been at great pains to emphasise that his theory does not assume that a
truths that is makes sense to think that some of my beliefs or a particular application of a concept may be false.39

The argument thus far shows that one can be certain that he possesses true knowledge of the content of one’s thoughts and -in light of the intersubjective nature of language- the content of the thoughts of his co-discussants. But is this enough to guarantee that one also has knowledge of what is the world like? How can we be sure that our body of beliefs is actually true? How can we be certain that our brains are not inside a vat of a scientist’s laboratory wired to all “normal” sensations? With this regard, Davidson notes that sceptics assume that knowledge of our minds enjoys some sort of secure status because of its immediacy, and that it is that immediacy that is supposedly necessary but missing when it comes to our knowledge of the external world.40 He argues that this assumption is tenuous because the mastery of language, which grounds the knowledge of what is inside one’s mind as well as other people’s mind, is possible only through knowledge of the world.

Specifically, Davidson asks the following question. Given that knowledge of any mind (one’s own or another’s) depends on the existence of a shared language, what conditions need to obtain for an interpreter to be able to interpret the verbal utterances of a speaker with success? In order to put the question of interpretation in its sharpest or most radical form,41 Davidson supposes that interpreter and speaker do not share the same language and asks what conditions would need to obtain for the former to interpret

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39 One conspicuous consequence of holism is that my beliefs are not made true because they correspond or refer to particular aspects of the world, for the ideas of correspondence and reference acquire their sense from the false assumption that we experience the world in bits, of which our sentences are supposed to be mental representations. D. Davidson, ‘Indeterminism and Antirealism’, Essay 5 in Subjective, Intersubjective, Objective (2001), 69, 78-80.
41 That is why he labelled this theory as the “Theory of Radical Interpretation”.
successfully the utterances of the latter. By discussing the problem of interpretation in this very difficult context, he brings to the forefront the kind of knowledge that is required for all linguistic understanding, without relying on any prior knowledge of the speaker’s language, beliefs or conceptual schemes.

Davidson argues that radical interpretation is only possible on condition that the interpreter credits the speaker with two attributes, which collectively amount to what he calls the *Principle of Charity in Interpretation*.\(^\text{42}\) First the interpreter must credit the speaker with the same apparatus that makes the interpreter capable of having thoughts and language, i.e. the interpreter must attribute to the speaker’s beliefs the same degree of holism or coherence featuring in his own body of beliefs (the *Principle of Coherence*). Second the interpreter must credit the speaker with the same ability to respond to aspects of the world that the interpreter attributes to himself (and to other users of his language) (the *Principle of Correspondence*).

Davidson’s argument demonstrates that, contrary to the assumption that gives scepticism its currency, knowledge of the content of any belief is only possible on the assumption that we, as the speakers, have a largely true view of the world. Our three varieties of knowledge (subjective, objective, intersubjective) are interdependent. Knowing the content of our minds and of the minds of others requires us to have knowledge of the shared environment in which thought acquires its content (so the idea of a

conceptual scheme which is unintelligible to us is incoherent), while knowledge of the world is only possible for creatures that are able to have and to communicate thoughts and beliefs about it.

To conclude, sceptics maintain that it is possible to understand the meaning of a person’s evaluative judgement and still be able to claim that this proposition cannot be objectively true or false. The coherence theory of truth and knowledge makes plain that this view rests on a misconception of what is involved in having a belief (indeed any propositional attitude) or understand someone else’s belief. To be able to understand any utterance whether one's own or someone else’s as a belief one must necessarily possess the concept of objective truth. It is suggested that this is of immense significance in the study of regulatory interpretation because it shows that we can intelligibly argue for right answers to questions of interpretation without subscribing to an ontological notion of truth.

4. The normative aspect of value scepticism: A critical appraisal

4.1. Introduction

The normative aspect of external scepticism and its appeal have been discussed already. It was argued that, as a normative doctrine, external scepticism attacks the idea of objective truth in matters of interpretation, first, by asserting that talk about objectivity introduces an weak

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44 It is interesting to note that in the course of exposing the sceptic’s challenge as incoherent, Davidson provided us with a theory of truth that proves correct an important part of the idea of interpretative attitude, on which the constructive account of regulatory interpretation was grounded. This is because his theory explained how it is possible for interpretive arguments to preserve the crucial space between what the participants in a practice believe that the practice requires and what the practice truly requires, by showing that truth and belief are connected to each other in a holistic manner.
conversational culture in the public domain and, second, by arguing that the constructive thesis is not attentive to considerations of procedural efficiency because the pursuit of right answers is more likely to bring public debate in deadlock. I will not spend more time on the first limb of this attack; the analysis above made plain that we have the capacity to get the interpretation of rules right without being stubborn, dogmatic or capricious. Rather I will concentrate on the second limb of the criticism, namely the argument that commitment to the chase for right answers is at odds with procedural efficiency.⁴⁵ Below I will unpack the critic's argument into more concrete claims against the constructive reading of regulatory interpretation and then I will try to address them as fully as possible.

4.2. Is the constructive thesis inconsistent with the demand for procedural efficiency?

Even if one accepts that there are right answers to questions of interpretation and that we can have genuine arguments about them, still one has reasons to refute the constructive thesis, for it is not enough to demonstrate the intelligibility of talk about right answers; one must also show that the search for right answers is a feasible and worthwhile project in light to the scarcity of resources and the peculiarities of regulation as a political institution whose prime concern is the delivery of efficient public

⁴⁵ On the notion of procedural efficiency see note 9 above. The discussion in this section echoes the parallel debate in jurisprudence concerning the extent (if at all) in which natural law theories can accommodate a basic set of intuitions that make legal conventionalism an attractive theoretical doctrine as, for instance, its commitment to pluralism, consensus, neutrality, modesty and procedural efficiency. For instance, S. Shapiro argues that the insights of legal conventionalism are incompatible with the natural law tradition. S. Shapiro, ‘Law, Plans and Practical Reason’, 8 Legal Theory (2002), 387 at 441. A defence of the opposite view is provided by Kyritsis. See, D. Kyritsis, ‘What is Good About Legal Conventionalism?’, 14 Legal Theory (2008), 135-166. The author makes special reference to Dworkin’s theory of law as integrity as an example of a robust natural law theory that is compatible with certain core postulates of legal conventionalism. Although there is some controversy as to whether law as integrity belongs to the natural law tradition, it seems that Dworkin does not object this. On this point see R. Dworkin, ‘Natural Law Revised’, 34 University of Florida Law Review (1982), 165.
This is exactly, what the critic doubts when he argues that the constructive thesis is at odds with considerations of procedural efficiency. He questions the capacity of regulatory interpretation to meet the demand for new and better interpretations (as the constructivist advocates) at a minimum time and cost. The critic evokes a number of reasons in support of his claim.

To begin with, he points out that it is a fact of life that people differ considerably in matters of value. The more it is important something, the more likely it is to raise disagreement and debate and the greater the chances are that the chase of right answers will bring decision-making into an impasse. Under these circumstances, procedural efficiency requires the bridging of differences so that both the regulatory authority and the regulated population read out from the same page. This is an essential precondition for otherwise it is not possible to maintain certainty and predictability and overall facilitate market co-ordination. Allegedly, the constructive account of regulatory interpretation is not attentive to this problem because it triggers friction and conflict. By contrast, the communicative thesis is by virtue of the fact that it places consensus into the forefront of regulatory interpretation.

Despite appearances, the constructive account of regulatory interpretation is neither hostile to procedural efficiency nor out of touch with the realities of regulatory practice. When the constructivist posits that regulatory interpretation should be understood as an argumentative practice in pursuit

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47 Obviously this will not be the case, if it takes the regulatory community ten years to resolve a trivial interpretive matter.

48 See the discussion on interpretive convergence and its rationale in chapter Four above, pages 176 to 179.
of rightness, he has a short of principled-interpretation in mind. Principled-interpretation is neither novel nor an extra-ordinary view of what actually happens in regulatory interpretation. It is implied in a number of long-established regulatory practices. More recently these practices have found expression in concrete policy initiatives concerning the design, interpretation and enforcement of rules by FSA. For example, the principles-based approach to regulation is an unequivocal manifestation of principled-interpretation. Similarly, consistency—one of the design objectives of the FSA Handbook- requires that regulatory provisions are internally coherent and that differentiation is permissible only where the regulator provides reasons explaining why deviation is considered appropriate. Finally a further aspect of FSA’s regulation that suggests that principled-interpretation is at play concerns the Authority’s approach to enforcement. In this connection FSA stressed its commitment to ensure that its decisions are consistent overtime and explained how past decisions affect present choices of what should be the appropriate mode of action.

The constructivist favours a form of principles-interpretation because he is alert, that interpretive judgments are often subject to irregularities and distortions even where they were the outcome of due process. Therefore, he envisages a theoretical scheme of regulatory interpretation where each interpreter is expected to ascertain the scheme of principles of political morality, that gives the best account of the practice of regulation, and use this as interpretive guidance. In doing so the interpreter is invited to contest his views with the views of others. He must consider alternative

50 A. Georgosouli, ‘The FSA Policy of Rule-Use: A Critical Appraisal’, 28(1) Legal Studies (2008), 119-139 at 121; and FSA, The FSA Approach to Enforcement, chapter 5 especially para. 23. Similarly, it is suggested that the Financial Services and Market Tribunal aids FSA in its task to conduct principled-interpretation.
51 This applies with equal force to every member of the regulatory community that partakes in the interpretation of regulatory requirements either as a regulatory official or as a regulated firm or as a consumer during the consultation process or during other subsequent stages. The source of the obligation to conduct principled-interpretation will be considered in while.
interpretations of the rule in question as well as the force of various arguments that support them and -after due reflection- adopt the interpretation that matches his conclusive judgement in “reflective equilibrium”. Principled-interpretation entrusts each individual member of the regulatory community with the task of developing the public standards of their community. It urges them to see this project not just a matter of negotiated trade-offs (as the communicative thesis does with its emphasis on interpretive convergence) but as dialectical enterprise that involves commitment to a fundamental public conception of justice.

The conduct of principled-interpretation provides the community of interpreters with a normative scheme that is conducive to organic change. If the associates in the regulatory community (especially the regulated population) accept that “they are governed not only by explicit rules laid down in past political decisions but by whatever other standards flow from the principles that these decisions assume, then the set of recognised public standards can expand organically”, as they become “more sophisticated in sensing and exploring what these principles require in new circumstances without the need for detailed legislation or adjudication on each possible point of conflict”. Undoubtedly, disagreement prolongs principled-interpretation. It is suggested however that if policy makers were to choose between a mode of interpretation that raises no disputes and a mode of principled-interpretation, in which disagreement constitutes an integral part, then principled-interpretation would be preferable because it furnishes the regulatory community with a vehicle for organic change, which otherwise

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52 John Rawls introduces the term “reflective equilibrium” to elaborate a liberal theory of political justice. In this particular case the term is used in a different context. Its essence, however, remains by and large the same as it implies a state of affairs where our judgements and principles coincide (they are found in “equilibrium”) and in which we are able to tell what principles our judgements conform and the premises of their derivation. J. Rawls, *A Theory of Justice* (2000), 18-19 and 42-43, especially, 18.

53 In this manner it resembles the model of legal interpretation that emanates from Dworkin’s thesis of law and integrity. R. Dworkin, *Law’s Empire* above note 2, 95-96 and 216; and N. Simmonds, *Central Issues in Jurisprudence* (2008), 231-236.

54 R. Dworkin, above note 2, 188-189.
would not have at all. After all we should not lose sight of the fact that by focusing exclusively on time constraints, we run the risk of missing another important parameter of sound decision-making namely the need to take into account the input of as many as possible.\textsuperscript{55}

Now, it is true that the critic is more likely to insist on his first point, perhaps more vehemently than ever before. He might complain that what the constructivist calls a “vehicle for organic change” for the regulatory community is nothing but a device in the hands of the powerful interest-group to pursue its own agenda in the regulatory arena.\textsuperscript{56} He would remind the constructivist that the community of interpreters is not made out of angels. Each interpreter acts out of self-interest and, if he has the chance to affect regulatory decision-making, there is no question that he will go ahead to advance his own interests without regard to any responsibilities that may derive from his de facto involvement in regulatory interpretation.\textsuperscript{57} The opponent would further add that the trouble with the constructive thesis is that it makes it so easy for the members of the regulatory community to act in such a manner. It does so, because it asks them to address interpretive disputes by drawing from a pool of contradictory and often conflict-ridden principles that reside in past political practice.\textsuperscript{58}

\textsuperscript{55} J. Surowiecki, \textit{The Wisdom of Crowds: Why the Many are Smarter Than the Few} (2004).
\textsuperscript{58} I use the term “past political practice” (and its equivalent “political history”) rather than “past legal practice” (or “legal history”) to suggest that the public standards or principles that may guide regulatory interpretation are not to be found in court decisions exclusively, but in whatever said and done by members of constitutional assemblies, legislatures, courts and administrative agencies. For a similar conceptualisation of “law practices” see, M. Greenberg, ‘How Facts Make Law’ in S. Hershovitz (ed), \textit{Exploring Law’s Empire} (2008), 225, 234.
This time the critic attacks the case for a constructive account of regulatory interpretation on two fronts. On the one hand, he invokes the problems of regulatory capture and rent-seeking to demonstrate the futility of asking those involved in the interpretive project to get things right. On the other hand, he points to the chaotic legal background where political values, principles and policies dwell, to argue that bringing these materials at the forefront of regulatory interpretation is more likely to do harm rather than good, for it is bound to allow for arbitrariness and bias.\(^59\)

With respect to the first fraction of the critic’s new argument, it should be noted that regulatory capture and rent-seeking are not peculiar to the constructive account of regulatory interpretation. The same problems would arise if a communicative type of regulatory interpretation were in operation, for there as well would be no point for committing oneself towards working out an agreeable interpretation of rules if one had the power to stir up regulatory decision-making without having to compromise one’s interests. In any case, the aim of a theory of regulatory interpretation is not to resolve problems like these. Its objective is to provide the best possible explanation of why this mode of conduct (regulatory capture) should be regarded as a problem at all; a practice that we should refrain from institutionalising; something that we have good reasons to resent and discourage. So, if there is a difference between the constructive thesis and the communicative thesis in this respect, then this is put down to their different line of reasoning. Whereas the constructivist declares that these practices are objectionable because they are incompatible with our intuition that a life worth living is a life that is governed by the Rule of Law\(^60\) rather than the rule of the

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The communicativist contends that these practices must be resisted only insofar as and to the extent in which they hinder the procedural efficiency of the regulatory process.

The second fraction of the critic’s latest critique—namely, the accusation that principled interpretation is unlikely to bear out the fruits it promises—is a version of the first one. That as well doubts the eligibility of the constructive scheme of interpretation to meet the demand for new and better interpretations. This time however attention is drawn to the chaotic and contradictory state of affairs of past political practice rather than to the imperfect nature of interpreters as human beings. Arguably this is a serious challenge to the constructive thesis because it claims that even if the problem of regulatory capture was vanished in some magical way, still regulatory interpretation, as it is envisaged by the constructivist, would fail to meet the tall order of “getting things right,” simply because there is enough in the reservoir of past political practice, for one to make in good faith whatever argument he wishes. Arguably, the communicative thesis is discharged from this problem, because it neither asks the interpreters to seek for right answers, nor urges them in vein to seek guidance by resorting to contradictory principles.

This accusation is based on a familiar complain, Critical Legal Studies enthusiasts make, about the condition of law. The trouble with this pessimist depiction of law is that it relies on a simplistic account of the Rule of Law, as full of inconsistencies is shared by critical legal studies scholars, positivists and interpretivists alike. R. Unger, What Can Legal Analysis Become? (1996), 65; J. Raz, Ethics in the Public Domain: Essays in the Morality of Law and Politics (1994), 277, 298-300; and R. Dworkin, note 2, 273. See further J. Waldron, Did Dworkin Ever Answer the Critics? in, S. Hershovitz (ed), Exploring Law’s Empire: The Jurisprudence of Ronald Dworkin (2008), 155, at 180.

contradiction. Law is far more complicated and precisely because it is so perplex in its nature, it is suggested that, there is nothing better one can do but try to put things in order, for nothing else will reveal whether an attempt can succeed or not. As Jeremy Waldron puts it in one of his eloquent articles on Dworkin’s idea of law as integrity, “it is not clear up front that attempts to argue in the mode of law-as-integrity are doomed to failure. If it were clear, we should have no reason to resist the siren charms of pragmatism … But sometimes legal argument looks promising, and when it does we are obliged to make the attempt…”

Yet, the justification of committing one self to principled-interpretation, even where the chances are to make mistakes, goes far beyond satisfying one’s adventurous spirit or curiosity to find out whether this project is going to be a success story or not. It emanates directly from our moral constitution and our social condition as members of a political community. These dictate that we act in important matters with integrity that is, according to convictions that inform our lives as a whole rather than capriciously. In addition, our moral constitution and our political state of being demand that we are allowed and enabled to play an active part in shaping and revising the public standards of our political community. Principled-interpretation, under the constructive vision of regulatory interpretation, makes this possible because it embraces a vision of the regulatory community whose members actively develop the public standards of their community because they treat their relationships as genuinely governed by these standards.

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64 The idea of regulatory interpretation under the constructivist lenses is much more a matter of attitude rather than a matter of institutional dynamics and power politics. Dworkin approaches legal interpretation in a similar way. R. Dworkin, 239, above note 2, 413, 190.
65 Above note 63, 155, at 181.
66 The regulatory community is part of the wider political community.
67 R. Dworkin, above note 2, 166.
Finally, one should not lose sight of the fact that principled interpretation furnishes the constructive thesis with a significant legitimacy advantage. Under the constructive reading of regulatory interpretation there is a reciprocal relationship between the regulatory Authority and the regulatees. It is not just the regulated population that is required to conduct principled-interpretation. Regulatory officials are asked to do the same. They are expected to justify their exercise of coercive power by showing how their decisions and actions flow from principles that the regulatory community unearthed out of past political practice.

There is one more argument against the constructive thesis that merits attention. The critic need not question the capacity of regulatory interpretation to bring fruits in order to show that the constructive thesis is at odds with considerations of procedural efficiency. As a matter of fact, the critic may not be a pessimist at all. His only objection now is that the search for right answers by way of principled-interpretation should be better left to the judiciary because it is better competent and, therefore, suitable to deal with this matter. In this connection, he might explain that he prefers the communicative thesis because the latter captures the following idea: that it is for the judiciary to detect and remedy interpretive mistakes and in this

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68 Here, I cannot pursue the question of legitimacy further. Suffice is to point out that whereas the constructive thesis answers the question “why should one obey a scheme of interpretation that opposes” in terms of the notion of reciprocity as a form of associative obligation, the communicative thesis seems to rely on the idea of consent or tacit consent. Neither of the two approaches to the question of legitimacy is free from problems. It is suggested however, that the appeal to reciprocity is less problematic. S. Perry, ‘Associative Obligations and the Obligation to Obey the Law’ and Dworkin’s response in S. Hershovitz (ed), Exploring Law’s Empire (2008), 183-205 and 304-305 respectively; R. Dworkin, Law’s Empire, 190-216; and A. J. Simons, Moral Principles and Political Obligations (1981), chs. 3 and 4.

69 Above note 63, 155, at 177; and J. Waldron, Law and Disagreement (1999), 189-191.

70 P. Craig, above note 46, chapter 12 particularly 388-393 and 400-401 and; R. Baldwin and J. Houghton, ‘Circular Arguments: The Status and Legitimacy of Administrative Rules’ (1986) Public Law 239 at 298. As I will explain in a while, the constructive theory does not make the absurd claim that regulators and judges should be regarded as performing the same role. All it says is that regulation must not be viewed as a domain outside the Rule of Law. By the same token, those involved in regulatory interpretation must be taken to act within the Rule of Law, for otherwise is not sensible to say that they are under an obligation to respect it!
manner to ensure that everyone is treated as equal by the law; it is not for
the regulator to bother with that; the regulator’s priority should be to ‘keep
things moving’ as efficiently as possible. In addition, the critic might take
issue with the suggestion that all members of the regulatory community bear
a special moral obligation; the obligation to treat regulatory interpretation as
a practice that involves commitment to a fundamental public conception of
justice, which each interpreter individually has a responsibility to identify for
himself and defend it against other competing conceptions. In this relation,
he might say that the assumption of a moral obligation to interpret rules in a
principled fashion is deeply problematic and unhelpful.

It is problematic because the only interpreter who is institutionally fit to
conduct principled-interpretation is the judiciary. There is a clear division of
labour between the judiciary and the regulatory authority. Whereas the
former has the task to ensure that deviations from the Rule of Law71 are
duly detected and remedied the latter’s job is to bring about certain policy
outcomes at the minimum possible cost; it is not for the regulator to look
out for right answers in questions of interpretation. By the same token, it is
incongruous to claim that each regulated firm and more generally everyone
that is involved in regulatory interpretation other than the regulator has the
moral obligation to carry out principled-interpretation first because it is unfit
and second because this heavy moral burden would deprive each interpreter
from the freedom to pursue one’s own individual goals and agenda.

The critic is right to complain that involvement in regulatory interpretation
should not yield one’s fundamental right of self-determination
unattainable.72 He is also right to point out that there is a division of labour
between the regulator and the judiciary, but the proposition that the

71 The difficulty to come up with a workable definition of the Rule of Law was discussed above in note 60.
72 See above note 8, 169 and 177.
regulator has the moral burden to conduct principled interpretation does not entail blurring the institutionally distinct roles of the regulator and the adjudicator. The regulator is not a judge and he should not act as if he were one, not least because he confronts different challenges in performing his mandate. If anything, the regulator’s concern is with the making and execution of public policy—not with justice. This, however, does not absolve the regulator from abiding by and acting within the premises of the Rule of Law. This duty emanates directly from the statutory mandate by virtue of which the regulator is placed in a privileged position to make exclusive use of the State’s coercive power in the name of bringing into fruition certain desirable policy objectives.\footnote{Up to this point it is useful to bring to mind the subtle Dworkinian distinction between the idea of integrity in legislation and integrity in adjudication. The first restricts what legislators and other lawmakers (e.g. regulatory agencies) may “properly do in expanding or changing” the system of public standards that prevails in a particular political community. The second requires the judiciary to treat “the present system of public standards as expressing and respecting a coherent set of principles”. Under this scheme judges are not allowed to make new law but to preserve and uphold the existing one. The past exerts some special power, which judges must not ignore. By contrast, policy makers and rule makers enjoy greater interpretive freedom when performing their institutional function, in the sense that they are allowed to be more creative when interpreting the public standards of the political community they represent. R. Dworkin, above note 2, 167 and 217; and note 56 at 142.} Furthermore, it finds expression in a wealth of court decisions on the discretion of administrative agencies to depart or change policies and the protection of legitimate expectations on the grounds of equality.\footnote{R v Secretary of the State for the Home Department, ex p. Ruddock [1987], 2 ALL ER, 518; R v Commissioner of Police of Metropolis ex p P, The Times, 24 May 1995; R v DPP ex p C, The Times, 7 March 1994; R v Secretary of the State for the Environment ex p West Oxfordshire District Council, [1994] COB 134; R v Ministry for Agriculture Fisheries and Foods, ex p Humble Fisheries (Offshore) Limited (CO/2158/92), 11; R v Secretary of the State for the Transport, ex p Richmond-Upon Thames London Borrow Council [1994] 1 WLR, 74 at 94 especially the statement of Laws J.; R v North West Lancashire HAE ex p A, D, G, [2002] UKHRR, 97; R(on the application of BAPIO Action Ltd) v the Secretary of State for the Home Department, [2007] EWHC, 199 which was affirmed by the House of Lords case R(on the application of BAPIO Action Ltd) v Secretary of the State for the Home Department, [2008] 2 WLR, 1073; and R (on the application of Niazi) v Secretary of State for the Home Department, [2008] EWCA Civ, 755. See also Y. Dotan, ‘Why Administrators Should Be Bound by their Policies’, 17 Oxford Journal of Legal Studies (1997), 23-41.}

With respect to the regulated firms and any other participant in the community of interpreters other than legal or regulatory officials, things are less straightforward. Although many social practices create reasons for acting in a certain way—in this particular case, conducting principled
interpretation— not all do and even fewer engender reasons that have the force of an obligation.\(^{75}\) Legal practice is one of them and so is regulation at least insofar as one is prepared to endorse the view that regulation is integral part of the practice of law. In this relation, it is argued that the moral duty to commit oneself to a principled-interpretation of regulatory requirements can be based on a conception of associative responsibility that emerges from their de facto involvement in regulatory interpretation.\(^{76}\) In any case the claim that interpreters are morally bound to conduct principled-interpretation does not intend to cancel out one’s right of self-determination. Rather, the constructivist introduces the idea of a moral duty because he wishes to remedy a discrepancy that would otherwise emerge (given the recent trend towards decentralised patterns of interpretive decision-making in financial regulation) if interpreters were given the freedom to shape interpretive decision-making without at the same time bearing the burden of responsibility for their judgements.\(^{77}\) Clearly the regulator and the regulated population do not share identical burdens of responsibility. It should be noted however that the more the regulated population is expected to play an active role in developing regulatory standards the greater the burden upon its members to treat relationships between themselves as typically, not just sporadically governed by these standards.\(^{78}\)

\(^{75}\) The term “social practice” is here broadly conceived encompassing all the different and widely divergent views about the nature and structure of the social practice currently on offer — in the case under examination, regulation.


\(^{77}\) The senior management responsibility regime —one of the main components of the FSA financial regulation, which is intrinsically linked with the implementation of principles-based regulation— seems to give support to the view that the regulated firms have a moral duty to conduct principled-interpretation, when, for instance, they have to decide how to comply with regulatory requirements. C. McCarthy, ‘Principles-Based Regulation —What Does it Mean for the Industry?’ *FSA Speech* (31 October 2006); and J. Gray and J. Hamilton, *Implementing Financial Regulation: Theory and Practice* (2007), 94-134.

\(^{78}\) In this sense, principled-interpretation has the potential of expanding and deepening the role of each individual interpreter in the regulatory context.
To sum up in this section I addressed the argument that the constructive account of regulatory interpretation is defective because it is not sensitive to considerations of procedural efficiency. I showed that when the constructivist maintains that regulatory interpretation should be understood as an argumentative practice in pursuit of rightness, he urges interpreters to conduct a principled-interpretation of rules namely, a mode of interpretation where everyone is invited to discern the scheme of principles of political morality, that gives the best account of the practice of regulation, to contest it against other competing conceptions and, after reflection, use his findings as interpretive guidance. Despite appearances to the contrary, principled-interpretation promotes the flourishing of procedural efficiency alongside other valuable states of affairs because it furnishes the community of interpreters with a vehicle for organic change. The latter enables them to meet the need for new and better interpretations without transgressing the premises of the Rule of Law.

5. Conclusion

The constructive account of regulatory interpretation is not free from criticism. In this chapter I examined an objection that takes issue with an integral aspect of the constructive thesis namely the idea that regulatory interpretation does and should aim at getting the interpretation of rules right. According to this objection, talk about “right answers” and “objectivity” in interpretation must be resisted first because there is no truth of the matter in interpretation and second because pretending that there is introduces an unsound conversational ethos in regulatory practice and overall traps the interpretive process into the pursuit of an unrealistic agenda. Since this line of reasoning borrows heavily from value scepticism - the influential school of thought that refutes the idea of objective truth in evaluative judgements- my project has been to explore its soundness by
locating the theoretical misgivings about the truth conditions of evaluative claims within the broader philosophical trend of external scepticism.

As a metaphysical doctrine, external scepticism proclaims to be “neutral” and “austere”. It is neutral in the sense that it is capable of questioning a whole scheme of beliefs about value without challenging the substantive evaluative claims. It is austere in the sense that it pledges to construct its criticism wholly independently of any positive evaluative claim or assumption. Both these features are problematic. With respect to “neutrality”, external sceptics maintain that their scepticism is not directed to substantive moral convictions because, they argue, moral judgements (Internal-propositions) and second order opinions (External-propositions) about them are not one and the same thing. A careful analysis of the structure of this argument made plain the artificiality of this distinction and further showed that E-propositions are only more redundant or more elaborate forms of I-propositions. With respect to “austerity”, external sceptics posit that we cannot make sense of objective truth unless we are ready to subscribe to an absurd ontological view of the world where values are “out there” and “part of the fabric of the world.” It was suggested that truth and objectivity need not be thought of in ontological terms and further argued that a proper account of our capacity to understand and interpret propositions of value entails that value-scepticism cannot be coherently formulated. Insofar as one is able to understand any kind of utterance as proposition, one is already committed to the idea that this proposition admits of true value.

The exploration of the metaphysical aspect of value scepticism also allowed the following conclusion to be drawn; that we have the capacity of getting the interpretation of rules right without being arrogant, dogmatic or
stubborn. Consequently, the accusation that the constructive thesis introduces an unsound conversational ethos in regulation fails. This is not the only normative claim that the external sceptic made. An additional and far more challenging criticism has been his suggestion that the constructive thesis must be rejected because it is at odds with considerations of procedural efficiency. It was argued that this claim fails as well. A closer look at the project of interpretation that ensues from the constructive thesis shed light on the idea of right answers in questions of interpretation under the constructivist account and further revealed the operationalisation of a principled mode of interpretation, namely a mode of interpretation that helps interpreters to meet the demand for new and better interpretations by furnishing them with a vehicle for organic change, which would not otherwise have.

The defence of the constructivist thesis against the sceptic’s objection brings the exploration of the nature of regulatory interpretation to an end. It also accomplishes the comparative analysis of the communicative and the constructivist view of the rationale for the interpretive shift in financial regulation and, with that, the examination of the policy of rule-use in financial regulation. It is now clear that the constructive theory should be preferred to the communicative one, because it is better able to accommodate the demand to conduct principled-interpretation (this emanates from people’s preoccupation with a collective practice that is essentially political in nature) and considerations of procedural efficiency.
CONCLUSION

This doctoral thesis examined the policy of rule-use in the UK financial regulation. It took the current FSA conduct of business regulation as a case study to engage with broader questions about the nature of rules, the nature of regulatory interpretation and how the Rule of Law shapes our understanding of the policy choices underlying the use of rules in public administration. The thesis consisted of two complementary parts. Part I - namely Chapters One to Three- considered the evolution of the policy of rule-use during the past twenty years of financial regulation. Part II –that is Chapters Four to Six- explored the grounds of this policy development by looking into the nature of regulatory interpretation.

Specifically, Chapter One offered some background information about the case study of the thesis. It discussed the subject matter of Conduct of Business regulation (COB) and overviewed the arguments for and against its economic rationale. It was argued that despite the fact that the debate on the economic justification of conduct of business regulation is still unsettled, FSA has been a strong advocate of regulation dedicated in protecting consumers of financial services and products. Consumer protection is included among the statutory objectives that FSA is bound to pursue and substantive conduct of business requirements occupy a significant part of the FSA Handbook covering a variety of issues as, for example, (a) client classification; (b) financial promotion; (c) information disclosure; (d) suitability and advice; (e) best execution (f) conflicts of interest and (g) unfair practices. Chapter One overviewed the core FSA conduct of business requirements and concluded with a brief examination of a number of amendments that are going to be introduced by the New Conduct of
Business Sourcebook (NEWCOB), which will implement the Markets in Financial Instruments Directive in November 2007. Particular reference was made to client classification, communication, product disclosure, conflicts of interest, best execution and appropriateness.

With COB regulation as their point of reference, Chapters Two and Three explored the policy of rule-use in financial regulation under the Financial Services Act 1986 and, under the Financial Services and Markets Act 2000 respectively. Special attention was given to the factors that shaped the policy of rule-use, its nature and objectives as well as its flaws. Chapter Two, which was devoted to the pre-FSMA era, identified three subsequent stages of policy development. The first phase had as its starting point the Financial Services Act 1986, which introduced a system of self-regulation under a statutory framework namely a sui generis system of command and control regulation with a degree of self-regulatory characteristics incorporated into it. The second phase was brought about by the New Settlement and the third one was launched by the Large Report. It was argued that in the middle 80's the eroded market homogeneity, the mounting uncertainty in the marketplace and the evident distrust among the DTI, SIB and SROs led to the production of extremely detailed and prescriptive conduct of business rules. The exercise of interpretive discretion was limited and the risk of litigation was high. Clearly the balance was tipped too much in favour of certainty and predictability at the expense of flexibility and adaptability. It was pointed out that ever since that time the policy of rule-use had as its primary aim to restore the balance between these conflicting policy objectives. To this effect, the New Settlement via the Companies Act 1989 put in place a number of measures to strengthen the position of self-regulation. It restricted the private right of action under section 62 of the FSA, it substituted the statutory requirement of “equivalent” level of
investor protection with the requirement of “adequate” investor protection and introduced a three-tier system of rules. A few years later, the Large Report continued the reform in the same spirit. This time however the focus of attention was on the standardisation of the procedural aspects of regulatory decision-making -especially with respect to the interpretation of rules- alongside the relationship between SIB and SROs. SIB’s new role as the leader regulatory Authority, the progressive reliance on Principles, the resort to cost-benefit analysis, the emphasis on regulatory transparency, the provision of concrete performance measures all testify a change of focus and a methodical attempt to bring into fruition a more sophisticated policy of rule-use that were purposive and compliance oriented.

The Large Report was short lived. Its underlying ideas however survived the unprecedented institutional reform of the UK financial regulation towards the end of the 90’s. These found its full expression in the launch of the Financial Services Authority and the Financial Services and Markets and Act 2000. Chapter Three explored this latest phase of the policy of rule-use. It overviewed the formation of the design principles and objectives of the FSA Handbook, it described the typology of the regulatory requirements and spelled out the nature of the FSA policy of rule-use. The following were identified as the prevailing characteristics of the current policy of rule-use: (a) the sophisticated architecture of the FSA Handbook, which manifests itself in the extensive use of regulatory provisions that are termed in high level of abstractness and generality, the complex and fluid structural inter-relation of the regulatory norms and the plethora of navigating tools that aim at making the Handbook user-friendly and accessible; (b) the purposive (“principles-based”) approach to rule use, which means that FSA produces, applies and enforces rules in a manner that is essentially outcomes-oriented; (c) its communicative nature namely, the distinctively participatory
dialectical practice that underpins the formation application and enforcement of rules and; (d) the risk-based approach, which makes possible the proportionate and cost efficient issuance of new rules or modification of the existing ones as well as the adoption of a targeted and commensurate compliance and enforcement strategy.

It was argued that in theory, the FSA policy of rule-use is sound. While the sophisticated design of the rules and their legal framework was intended to make rules more accessible and easy to understand, purposiveness aimed at fostering compliance with the spirit rather than the letter of the regulatory norms, encouraging the development of market-based solutions and overall reducing the cost of rule-use. Similarly, the inclusion of communicative elements and the adoption of a risk-based approach were intended to cement the participatory and reflexive nature of the Authority’s policy of rule-use in an economically efficient manner. This withstanding, FSA’s approach to the use of rules seems to be problematic in practice. As it was shown, the Handbook remains complex and hard to read. The emphasis on high-level principles tips the balance too much in favour of flexibility and at the expense of certainty and predictability. It is also unlikely to reduce the cost of regulation because it involves the maintenance of a costly communication network. Purposiveness precipitates the creation of a new climate of risk and uncertainty. The adoption of conversational style of rule-use triggers conditions of regulatory capture, and -to the extent it pushes institutional developments towards heterarcical structures of governance-breeds problems of cooperation and coordination. ARROW II has its own limitations as a technical device for the proportionate, targeted and efficient use of rules, not least because future risks may turn out to be different from those predicted. Finally, the implementation of MiFID may have reduced the size of the New Conduct of Business Sourcebook (NEWCOB),
however, it is generally considered to be an additional source of constraints holding back FSA’s plans for innovation and experimentation.

The analysis in Part I made plain that financial regulators in the UK have always sought to accommodate conflicting policy objectives like flexibility, certainty and predictability and that for nearly two decades they have been consciously trying to direct the interpretive strategy of the regulated population towards adhering with the spirit rather than the letter of the regulatory requirements. That said the major difference between the present and the past regulatory practice lies in the ways in which these objectives are brought into fruition. Nowadays all these goals are pursued through novel means which insinuate inter alia the abandonment of legal rules as means for defining jurisdictional boundaries, the opening up of the regulatory process, the de-centralisation of the interpretive decision-making and the attempt to bring about legal certainty by way of managing the interpretive process per se rather than by way of redrafting regulatory requirements. It was suggested that all these developments signal out the emergence of an interpretation-centric approach in the policy of rule-use.

Indeed, past failure helped the architects of the regime to become conscious of the limitations of legal text as a form of guidance for regulating behaviour, the futility of attempting to exhaust all possible applications of the rule within its wording, the inevitability of re-interpreting regulatory requirements in the presence of perpetual change in the marketplace and the importance of sharing a common understanding of the regulatory norms. Once these lessons were learnt the architects of the regime changed their perception of the nature of the problem and of the means of addressing it. It became clear, that the fluidity of legal interpretation did not need to be treated as a sign of weakness but as an indispensable property of the nature
of rules, which secured their adaptability and endurance across time and on
the other hand allows interpretive mistakes to be duly detected and
remedied. Therefore, the objective of the policy of rule-use was no longer to
produce rules, which would be self-contained in terms of their meaning, but
to regulate the interpretive practice that attributes meaning to rules in light
of the idiosyncratic and constantly evolving circumstances of each particular
case.

A major consequence of this change of attitude was the gradual
transformation of self-regulatory elements into a centrifugal regime of meta-
regulation, where the attainment of policy objectives is pursued by way of
regulating the interpretation of rules per se rather than by way of opting for
different combination of rule-type and rule-restructuring. In this new
institutional set up, the de-centralisation of interpretive decision-making has
been so immense that regulatees have a much more active and indeed
burdensome role to perform in making sure that they regulate themselves
properly. To assist them in this challenging task, FSA officials too have
started to change the way in which they perceive their role. In the FSMA era
‘being a regulator’ resembles to being in the role of a facilitator of a complex
network of communication, which is interpretive in nature and whose aim is
twofold: to explicate, review, and rework the essence of regulatory norms;
and to bring about cultural change as to what it means ‘to be regulated’ and
what it is like to ‘abide by the rules’. Contrary to what one would expect
from a statutory-based system of regulation, these are now discharged from
any connotations of passive adherence with exogenous commands coming
directly from the above. More than ever before, the regulated population is
asked to work out for itself and on ad hoc basis what it is like to internalise
basic moral norms into its day-to-day business, and it is deemed capable to
become cognisant of the collective responsibility that its active participation
in regulation entails.

An additional consequence of the interpretive shift in the policy of rule-use has been the institutionalisation of the perpetual re-assessment of what regulatory norms require in terms of acceptable and non-acceptable conduct. This development marks a radical departure from the past. In old days, the proposition of putting into operation a policy regime that would embrace the constant review of the interpretation of rules had been received with scepticism and suspicion, given that the frequent changes in the drafting or interpretation of rules were thought to be a source of legal uncertainty and poor public accountability. More recently, however, the constant revision of the interpretation of regulatory requirements has been welcomed as the best possible way to guarantee the production of new and better interpretations in light of the changing market landscape.

Whereas the aim of Part I was to examine the development of the policy of rule use in financial regulation, the purpose of Part II was to account for the grounds of the interpretive shift in FSA’s policy of rule-use by drawing on the nature of regulatory interpretation. Since studies on the nature of interpretation in the regulatory context have been rudimentary a great part of the second half of this thesis was devoted to the elaboration of a theoretical description of what it is like to interpret rules in the regulatory domain. In this connection, Chapter Four construed the communicative thesis drawing on the main ideas illustrated in Professor Black’s Rules and Regulators— one of the most acclaimed works in the current literature on the use of rules in public administration. Chapter Five brought attention to some difficulties that are endemic in the communicative thesis and argued for an alternative account of regulatory interpretation—the constructive thesis. In addition it fleshed out the implications of these two alternative
accounts of regulatory interpretation with respect to the grounds for the interpretive shift in financial regulation. Finally, Chapter Six defended the case for a constructive reading of regulatory interpretation against certain objections.

Specifically, the discussion started with a brief overview of *Rules and Regulators*, where Julia Black develops a thesis for the nature and use of rules in financial regulation with the view of proposing ways in which we can make more effective use of them. Chapter Four brought attention to a wealth of insights, which –when put together- comprise a very interesting account of the nature of regulatory interpretation. Starting from the observation that one of the basic ideas in *Rules and Regulators* is that interpretive convergence is crucial for using rules effectively, the analysis progressively spelled out all those assumptions that lie beneath this idea and constitute what it has been called a communicative account of regulatory interpretation.

According to the communicative thesis, interpreting rules in the day-to-day regulation equals to communicating one’s personal beliefs about how regulatory requirements should be understood. It is an opportunity for sharing information and most importantly for reconciliation through persuasion. Significantly, the community of interpreters is seen as the only source of interpretive authority. What the rule in question means cannot stand independently of what the community of interpreters think it means, based on shared background of beliefs, intentions and expectations. Therefore, the subject matter of interpretation is not the rule itself but the interpreters’ utterances. Now, given the plethora of equally valid meanings that can be attached to a rule it becomes crucial that regulatory interpretation should work towards cultivating a shared understanding of
regulatory requirements and ultimately towards interpretive convergence. The communicative thesis is compelling. It finds direct support to our common sense as well as to our fundamental intuitions about the moral constitution of the members of the regulatory community, which demands that they are not put aside when it comes to decide issues such as the production of new rules or the interpretation of existing ones. Moreover, it offers an account of regulatory interpretation according to which financial regulation -and consequently the use of rules- should be procedurally efficient.

Despite its appeal, Chapter Five showed that the communicative account of the nature of regulatory interpretation is far from satisfactory. Taking into account that the underlying assumptions of the communicative thesis touch upon very controversial issues in relation to interpretation, it was suggested that before assessing the robustness of the communicative thesis it would be essential to gain a deeper understanding of the practice of interpretation in general. To this effect regulatory interpretation was compared with the practice of interpretation in literature. The comparative analysis made plain that literary interpretation and regulatory interpretation are identical in a number of fundamental respects including the institutionalisation of authoritative interpretation, the tendency to treat the interpretation of the text (literal or legal as the case may be) as interpretation of an ‘object’ that stands independently from its author and/or interpreter and the genuine commitment to make the subject of interpretation the best it can be –a commitment that frequently fuels rational disagreement about matters of fact as well as about matters of value.

The application of all these insights to regulatory interpretation revealed a picture of interpretation that is different from the one offered by the
communicative thesis. Specifically, the analysis made plain that the subject matter of interpretation is not the interpreters’ utterances as the communicative thesis assumes, but the rule itself. Similarly, the point of interpretation is not to attain consensus (interpretive convergence) but to make the rule in question the best it can be, paying attention to a number of considerations, which work as constraints over one’s interpretive discretion. Moreover, the discussion on the practice of interpretation divulged that interpreters develop an idiosyncratic interpretive attitude towards the subject matter of interpretation. They treat it as an object that stands independently of their intentions and beliefs in order to allow space for error and correction through rational criticism and deliberation. More importantly though, the comparative analysis revealed that the communicative thesis offers a theoretical framework for the rationalisation of regulatory interpretation, that is neither workable nor appealing in practice.

In light of these difficulties, the possibility of an alternative account of regulatory interpretation (the constructive thesis) was explored. Borrowing from Dworkin’s analysis of the practice of interpretation in law and in particular the notion of interpretive attitude, Chapter Five proposed a theoretical account of regulatory interpretation that describes this practice – not simply as an occasion for improving communication among the members of a community of interpreters but- as a dialectical practice whose ultimate objective is to meet the demand for new and better interpretations of the regulatory requirements in accordance with the conditions of interpretation that are set out by the political history of this practice.

The two theoretical accounts of regulatory interpretation represent two alternative schools of thought with respect to the grounds for the interpretive shift in the policy of rule-use in financial regulation. According
to the conversation thesis, the gradual adoption of an interpretation-centric approach to the policy of rule-use is justified as an attempt to secure the effective use of rules by remedying failure of communication between the regulator and the regulated firms. On this account the rationale for the interpretive shift in regulatory interpretation draws on the need to combat information asymmetries and interpretive divergence to the extent in which they impede effective regulation. According to the constructive thesis, the interpretive shift in the policy of rule-use is seen as an initiative whose purpose is to facilitate the wider regulatory community in meeting the demand for new and better interpretations by duly identifying and remedying interpretive mistakes before and where possible in preclusion of judicial interference. Significantly, on the constructive view, the interpretive shift is not justified in terms of informational discrepancies and interpretive divergence. Rather, its rationale is grounded on an idea of regulatory interpretation as the ultimate dialectical practice that commands and encourages the participants of the wider regulatory community to work out the public standards (“principles”) that govern their inter-relations.

The constructive account of regulatory interpretation is not free from criticism. Of particular importance is the objection that the constructive thesis must be abandoned either because—contrary to what it holds—there is no right answers to questions of interpretation or because it is not compatible with considerations of procedural efficiency. On this view there is no truth of the matter in questions of interpretation. Pretending that there is introduces an unsound conversational ethos in regulatory practice and traps the interpretive process into the pursuit of an unrealistic agenda. Since this line of reasoning borrows from value scepticism—the influential school of thought that refutes the idea of objective truth in evaluative judgements, Chapter Six considered its soundness by locating the theoretical misgivings
about the truth conditions of evaluative claims within the broader philosophical trend of external scepticism. To this effect it assessed the perceived merits of external scepticism as a metaphysical and as a normative doctrine.

As a metaphysical doctrine, external scepticism proclaims to be “neutral” and “austere”. It is neutral in the sense that it is capable of questioning a whole scheme of beliefs about value without challenging the substantive evalulative claims. It is austere in the sense that it pledges to construct its criticism wholly independently of any positive evaluative claim or assumption. It was argued that both these aspects of external scepticism rely on flimsy premises. Whereas the claim to neutrality is based on an artificial distinction between moral judgements and second order opinions about them, the claim to austerity fails because it assumes that the only way we can make sense of (objective) truth is to subscribe to a surreal world ontology where values are “part of the fabric of the world.” Drawing on the philosophy of Donald Davidson, it was suggested that (objective) truth need not be thought of in ontological terms and further argued that a proper account of our capacity to understand and interpret propositions of value entails that value-scepticism cannot be coherently formulated. Insofar as one is able to understand any kind of utterance as a proposition, one is already committed to the idea that this proposition admits of true value.

In light of the flaws of external scepticism as a metaphysical doctrine, the sceptic’s claim that being committed to the chase for right answers engenders a weak conversational ethos cannot sustain. However, this is not the only normative claim that the external sceptic made. An additional and far more challenging criticism has been his suggestion that the constructive thesis must be rejected because it is at odds with considerations of
procedural efficiency. It was argued that this claim fails as well. Chapter Six considered the constructivist’s idea of rights answers to questions of interpretation, to the effect of making plain that -on the constructive reading of regulatory interpretation- the commitment to right answers equals to a commitment to principled interpretation namely a mode of interpretation that is similar to the one currently practised in the UK financial regulation and which helps interpreters meet the demand for new and better interpretations by furnishing them with a vehicle for organic change, which would not otherwise have.

The analysis in Part II made plain that the communicative thesis of regulatory interpretation and its constructive counterpart allow for two alternative answers to the question about the grounds for the interpretive shift in the policy of rule-use. Grounded on a conception of regulatory interpretation as an exchange of information that is prone to fail, the communicative thesis justifies the interpretive shift in financial regulation as a tactic that aims to remedy failure of communication between the regulator and the regulated population. Contrary to the communicative account, the constructive thesis views regulatory interpretation as the ultimate dialectical practice that commands and encourages the participants of the wider regulatory community to work out the public standards that govern their inter-relations paying attention to the political history of this practice. In light of this, it explains the gradual move towards an interpretation-centric regime as a policy initiative that aims to meet the demand for new and better interpretations by duly identifying and remedying interpretive mistakes before and where possible in preclusion of judicial interference. It was argued that the constructive thesis is preferable to the communicative one because the ideas of interpretive attitude and principled-interpretation, on which it is based, make it sophisticated enough to accommodate two
fundamental intuitions about the practice of regulation; the intuition that – since the use of rules entails the monopolistic exercise of the State’s coercive power – the resolution of interpretive disputes in the regulatory context must be the outcome of a genuine commitment to a public conception of justice, rather than the product of unprincipled and therefore arbitrary negotiated trade-offs; and the intuition that procedural efficiency matters in the sense that scarce resources should be used for purposeful activities rather than wasted in the pursuit of frivolous and unrealistic projects.

This doctoral thesis contributed to the current literature on the use of rules in public administration in general and on financial regulation in particular in a number of ways. First of all, it complemented earlier studies on the use of rules in financial regulation by offering an up to date discussion of the recent policy developments with respect to the formation, application and enforcement of rules after the launch of the FSMA and the establishment of the Financial Services Authority. In this connection it considered how recent institutional reform confirmed the transition from a rule-centric towards an interpretation-centric regime, it explored the rationale for this policy developments, it assessed its merits and flaws and, last but not least, it drew attention to the likely impact of the increased Europeanisation of the UK financial regulation to the evolution of the policy of rule-use.

In addition, an extensive part of this thesis was devoted to the examination of the nature of interpretation in the context of regulation – a theme that up till now had been relatively underdeveloped. In this relation, it proposed two alternative theoretical accounts of the nature of regulatory interpretation; the communicative thesis, which regards interpretation as a form of communication that is bound to fail due to informational asymmetries and interpretive discrepancies, and the constructive thesis, which views
regulatory interpretation as the ultimate dialectical practice that commands and encourages the participants of the wider regulatory community to work out the public standards that govern their inter-relations paying attention to the political history of this practice.

Furthermore, this thesis demonstrated how Dworkinian jurisprudence could inform our understanding of the nature of interpretation in the regulatory sphere and further enrich our apprehension of policy developments in the field of financial regulation. Specifically, by resorting to the doctrines of interpretive attitude and integrity in interpretation, it proposed a theoretical framework for making sense of policy developments with respect to the use of rules that departs from and at the same time challenges a number of commonly accepted views in scholarly writings in this field of law. For example, it argued that -when it comes to the rationalisation of policy developments with respect to the use of rules in the regulatory context- one must look at the norms underlying these developments rather than the social context in which they take place. In the same spirit, it propounded the relevance of right answers to questions of interpretation and showed that commitment to “get things right” neither introduces a weak conversational ethos nor is bound to bring regulation into a deadlock. Moreover, it suggested that what is important in regulatory interpretation is not to reach consensus, as it is widely thought, but collectively to be able to work out new and better interpretations of the regulatory norms in light of a public conception of justice.

Finally, this doctoral thesis proposed that the study of the use of rules in public administration does not have to be incidental. It could be thought of as a distinct policy regime with its own unique subject matter and policy objectives. In this relation it was suggested that policy approaches to the use
of rules could be of two sorts: rule-centric or interpretation-centric.\(^1\) Rule-centric regimes identify with policies that take the effectiveness of rules as predominantly a function of the rules themselves. Therefore, their focus is on the production of self-contained and static regulatory norms. These regimes are associated with command and control regulation or more generally with regulatory settings that are vertical, legalistic and prescriptive in character rather than horizontal open and participatory in nature. Ascribing meaning to regulatory requirements is not regarded as a common interpretive project. As a matter of course, the exercise of interpretive discretion is tightly controlled and the outcome of interpretive-decision making is dictated. Deliberation by way of self-regulatory configurations may be a feature of the regulatory system. Nonetheless its nature is symbolic rather than substantive not least because self-regulation is never fully operationalised. Interpretation-centric regimes differ in that they regard rule effectiveness as mainly a function of their interpretation. Therefore policy makers and regulatory officials place emphasis on the regulation of interpretive process that makes possible the formation application and enforcement of rules rather than their design. They are associated with meta-regulation and market-based regulatory settings that are substantially open, participatory and discursive in nature and whose implementation involves the decentralisation of interpretive decision-making. Significantly, under an interpretation-centric regime, regulatory interpretation is treated as a common dialectical process, which is administered but never curtailed by the regulator.

As far as the aims of this doctoral thesis are concerned (to examine the evolution and rationale of the policy of rule-use in financial regulation and

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\(^1\) In practice, approaches to the use of rules may not be 'purely' rule-centric or interpretation centric. This distinction, however, remains useful not least because it offers a more comprehensive theoretical framework for the study of the interaction of the policy of rule-use with other regulatory policies (e.g. enforcement) and for making sense of the parameters of success or failure of the various regimes.
prove debate) my task is now complete. However, due to the limited space available several issues were not fully addressed. For instance, I argued for a constructive theory of regulatory interpretation but I stopped short from spelling out its institutional implications. I pointed to the presence of evaluation in the interpretation of regulatory requirements but I did not fully explore its interaction with the use of highly technical language in assessing the appropriate mode of action (e.g., cost-benefit analysis and Arrow II). I referred to the notion of rule-effectiveness but I did not consider in detail how this concept should be understood. Moreover, my account of the criticism against the constructive thesis was not an exhaustive one, given that some commentators may take issue with a number of other aspects of my argument—notably, the suggested dissemination of competences between the regulator and the regulatory population. In this regard, one might counter-argue that regulatees could benefit by the regulatory Authority's decisions only if they could establish the purpose and content of their existence “in ways which do not depend on raising the very same issues which the authority is there to settle.”² Clearly, these themes should be addressed as well alongside a range of other issues including a critical overview of the new dynamics between public administration and the judiciary, a critical appraisal of the doctrinal background underpinning contemporary studies of the use of rules in public administration and how the insights into the nature of interpretation in financial regulation could apply to other regulatory contexts (utilities, environmental protection etc). Undoubtedly, this is not going to be an easy project. It will be, however, an intellectual journey worth taking.

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