

## THE FIRST HURDLE FOR FINANCIAL SERVICES AUTHORITY ("FSA") PRINCIPLE-BASED REGULATION

The FSA is in the process of changing the way it regulates financial services in the UK. The FSA wants firms to focus on the consequences of their actions rather than on rigid adherence to specific rules.

The FSA started with a very large handbook containing detailed rules and guidance. It has reduced the size of its handbook and the firms it regulates are increasingly expected to determine whether a particular action will be viewed by the FSA as a breach of their rules by reference to a small number of high level principles. This new approach requires the management of FSA regulated firms to apply their own judgement about whether a particular action would breach the FSA's general principles.

### Fox Hayes v FSA

The FSA has described the change to principle-based regulation as an opportunity for firms to decide for themselves how best to operate their businesses so they conform to the regulatory outcome required by the FSA. Principle-based regulation brings an increased flexibility but also an increased uncertainty and difficulty in predicting the FSA's reaction to a firm's conduct. The challenges faced by both the FSA and regulated firms under the new approach is neatly illustrated in the decision of [Fox Hayes v FSA](#) made by the Financial Services and Markets Tribunal (the Tribunal).

Fox Hayes, a firm of solicitors, had approved the wording of financial promotions made by its clients, an unauthorised overseas company, to UK

investors. The FSA imposed a fine on Fox Hayes on the basis that:-

- (1) they did not take reasonable steps to ensure that the financial promotions were clear, fair and not misleading; and
- (2) they had reason to doubt that their clients would deal with customers in the UK in an honest and reliable way.

### Appeal

Fox Hayes appealed to the Tribunal and the FSA expanded its claim to include the allegation that Fox Hayes had also breached one of the FSA's high level principles which required firms to conduct their affairs with due skill, care and diligence. Following the earlier decision of the Tribunal in [Jabre v FSA](#) it was accepted that it was open to the FSA to do this. It would therefore appear that firms should be prepared for the FSA to allege breach of any of their 11 high level Principles for Business before the Tribunal, whether or not they found such breach at any earlier stage in the enforcement action.

The FSA argued that Fox Hayes had breached the requirement to act with due skill, care and diligence by not realising much earlier that their overseas clients were operating a 'boiler room' and offering free investment reports as an inducement to facilitate subsequent pressure selling by

telephone of shares not listed in any major stock exchange. The FSA also argued that Fox Hayes should have put more weight on the warnings contained in press releases they had issued about boiler rooms in general and about Fox Hayes' client in particular. Fox Hayes had written to the FSA asking whether there were grounds for not acting for their client. The FSA responded without providing any specific information and saying it was a commercial decision for Fox Hayes as to whether they acted for any client. The FSA never said Fox Hayes should cease to act for any client. Fox Hayes were placed in a position of having to make an informed judgement based upon the FSA's high level principles.

### The decision

The Tribunal criticised the press releases issued by the FSA about boiler rooms saying they were not direct enough and were confusing. The Tribunal said the FSA "cannot have it both ways. Either warnings should be given in clear and fair language but, if that cannot be done, then it has to be accepted that the statements cannot fairly be treated as warnings." The Tribunal decided that Fox Hays had not breached the requirement to act with skill, care and integrity and placed weight on the FSA's failure to say that Fox Hayes should cease to act for their client.

Whether the FSA's drive towards more principle-based regulation continues will depend in part upon whether it succeeds in enforcement actions based upon alleged breach of those principles. If it does not succeed the FSA might be forced to either back track on its approach and revert to more detailed rules or issue increasingly complex guidance on how the principles should be interpreted and that would largely defeat the purpose of the change of approach by the FSA in how it regulates.

The FSA has now applied for permission to appeal the decision of the Tribunal in [Fox Hayes](#). This is the first time the FSA has sought permission to appeal a decision of the Tribunal. The FSA say they made the application because they believe that the Tribunal has made errors of law in interpreting the relevant regulatory rules. If permission to appeal is granted it will provide the Court of Appeal with an opportunity to comment on principle-based regulation.

### Comment

A consequence of principle-based regulation is that the FSA needs to be able to take enforcement action against firms that it considers are in breach of its general principles. If the Tribunal does not uphold the FSA's decisions, as they did not in Fox Hayes, the FSA's drive towards principle-based regulation could start to unravel.

The other side of the coin is that firms that are the subject of an enforcement action based upon principle-based regulation may feel genuinely aggrieved at the lack of regulatory clarity that has led them to blot their copy book with all the attendant reputational, commercial and financial consequences which may follow. For large organisations, a well founded relationship with the regulator may prove to be key in avoiding such an action or negotiating a satisfactory conclusion. For small firms an appeal from the decision of the FSA to the Tribunal may be a bridge too far if they do not have the resources to mount such a challenge. The FSA has recognised that principle-based regulation presents specific

challenges for smaller firms and that they need to be very clear with such firms about what they require them to produce as outcomes.

In the meantime, the Fox Hayes appeal will be watched to see if the FSA's change to the way it regulates financial services is still on track.

**If you would like any further information, please contact either of the following:**

**Richard Highley**  
**DDI: 020 7293 4574**  
**E: rhighley@dac.co.uk**

**Robert Viney**  
**DDI: 020 7293 4106**  
**E: rviney@dac.co.uk**

**This publication is not a substitute for detailed advice on specific transactions and problems and should not be taken as providing legal advice on any of the topics discussed.**

#### LONDON

6-8 Bouverie Street  
 London EC4Y 8DD

T +44 (0)20 7936 2222  
 F +44 (0)20 7936 2020  
 DX 172  
 E daclon@dac.co.uk

#### LONDON MARKET

85 Gracechurch Street  
 London EC3V 0AA

T +44 (0)20 7936 2222  
 F +44 (0)20 7293 4888  
 E daclon@dac.co.uk

#### MADRID

Paseo de la Castellana, 20  
 2ª Planta  
 28046 Madrid

T +34 91 781 6300  
 F +34 91 576 8669  
 E dacmadrid@dacspain.com

#### MANCHESTER

60 Fountain Street  
 Manchester M2 2FE

T +44 (0)161 839 8396  
 F +44 (0)161 839 8309  
 DX 14363 Manchester  
 E dacman@dac.co.uk

#### MEXICO CITY

Av. Insurgentes 950-9  
 Colonia del Valle  
 Delegación Benito Juárez.  
 Código Postal 03100  
 México D.F.

T +52 551 107 6056  
 F +52 555 687 6849  
 E dacmexico@dacmexico.com

#### ST ALBANS

60 Victoria Street  
 St Albans  
 Herts AL1 3XH

T +44 (0)1727 893 200  
 F +44 (0)1727 797 720  
 E dacstalbans@dac.co.uk