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Regulation, Jim, but not as we know it

The new Financial Conduct Authority will have a more human and sophisticated approach than its predecessor, says chief executive Martin Wheatley. ***Julian Sampson*** *beams up the latest FCA thinking, but is worried that the supervisor's unclear expectations could leave firms in deep space.*

City lawyers Ashurst recently conducted an unscientific survey among regular attendees of their monthly Regulatory Breakfast Briefing. They were asked whether they thought the change from Financial Services Authority to Financial Conduct Authority would bring a marked shift in regulatory supervision and agenda: 43% said 'yes', 57% said 'no'.

You might well understand why the response was thus. You may feel the same way. Notwithstanding that we're now into the third month of the new regime, much of the past appears recognisable in the present. And that is welcome. Thus, in the first months of its life, the FCA has picked up many of the batons handed to it by the FSA and continued to run with them. For example, it has continued work started by the FSA on LIBOR by introducing a new regulated activity of administering a specified benchmark. It is investigating RBS IT failures that took place in 2010 and has issued sundry other notices that had been in the FSA's pipeline. Even the FCA's much publicised and oft discussed new powers of intervention have been so much chewed over that they already seem like yesterday's news. (However, that is sure to change when those powers are actually used).

So one can understand why the compliance professionals at breakfast thought things were 'business as usual'.

But that's not the view of the FCA. When those same survey findings were put to the FCA head of supervision and board member Clive Adamson at a later Ashurst seminar, he was, to use an understatement, disappointed. At the risk of putting words into his mouth, he expressed a view that the creation of the FCA was a pivotal moment in UK regulation, that there were very high expectations of them and that the FCA would indeed be a very different supervisor.

Yet what is truly different? What has come about since the FCA took up its powers on 1 April that is really new? In answering this question, we should look at the first documents issued by the FCA after that date, the things they've been working on for a while but saved to release once they had their full powers. In them are the keys to understanding how the FCA will in reality be different.

Martin Wheatley's first speech after the launch of the FCA was on 4 April and two related occasional papers were released to coincide. He had already spoken about the FCA's role in protecting consumers and institutionalising customer service (see the 3 March speech), so his 'maiden' speech needed to be new – and it certainly was. He took the opportunity to introduce to most of the regulated world the concept of behavioural economics. And what's that all about? As he said, "I want the FCA to use its new powers and remit to bring a more human face to the regulation of financial services. A more pragmatic, sophisticated approach to regulation. To be a little more like Captain Kirk, perhaps a little less like Mister Spock."

Do not adjust your tricorders! Yes, that is what he said. Over the years, we've become used to some eye-catching and headline grabbing imagery in speech-making from senior FSA folk: we've had "be afraid", "barking dogs" and "shooting first". Yet this is really pushing the boat – or should that be starship? – out.

But what does Wheatley mean? His comments deserve reproducing and he explains:

> "One of the most significant challenges for modern financial regulators and financial services alike is to recognise that we operate within this very human environment. A fallible world governed and directed by psychology…"

However, says Wheatley, we have failed to recognise this 'human' environment in regulatory practice:

> "Yet one of the features of regulation historically was that it was all about compliance.

It was almost robotic. Were a particular set of rules followed and boxes ticked? Could a firm demonstrate and document that it had followed those rules to the letter? Did firms disclose the full, un-redacted detail of their products to customers? ..."

This 'robotic' regulation had negative customer outcomes:

"But in many cases this reliance on rules, processes and disclosure simply encouraged firms to hand over more information to customers who were already confused. More text, more figures, more legalese…"

It's just not satisfactory to give the customer the information and expect them to make a good decision. As he says:

"'buyer beware' does become harder to defend when customers are buying seriously complicated financial products… there are questions that many investors simply may not ask because we are humans, not automatons. Susceptible to behavioural biases, to framing, to anchoring, to poor decision making…"

This is very interesting and worthy of deeper consideration. We can all recognise some fundamental truths here and would not seek to defend the most egregious examples of poor practice that he cites. But for most of us, trying to advise a customer honestly, what are the practical policy outcomes from behavioural economics? Here Wheatley provides some clues, but declines to give much detail. The glimpses we are given include the FCA looking at areas like auto-enrolment and auto-renewal. Muses Wheatley: "Why do so many customers take no action when the letter, email or T&Cs tell them their fantastic sounding rate is ending and they're being shifted to a far lower, far less attractive rate of interest?"

More pregnant with possibility is what Wheatley says about 'complex' products. In his words:

"Could we also use behavioural economics to weed out products that are too complex for their target market – and may even be specifically designed to benefit from consumer mistakes? ... Many structured products fall in this category – products with too many moving parts; products that are almost impossible to take a rational decision on. So you [the consumer] revert to the instinctive – what is the headline promise; do I like the look of the salesman; is there a pot of gold on the poster?"

Thus Wheatley states his belief that some firms may use behavioural economics "for their own Machiavellian ends" – for example, by using attractive imagery in financial promotions that is designed to elicit a positive response from the consumer. He is returning to a theme he first raised in January 2012 when he spoke of "walking in the customer's shoes" – that some products are just too complex for folk and that it is the FCA's role to decide what they can and cannot reasonably understand. As he said then:

"We have to realise that consumers aren't always in a position to take responsibility, because of their lack of financial knowledge and because we have to take a reasonable approach to what a normal person can understand about complicated products and risks."

But beyond this, Wheatley leaves us hanging, between the firm ground of certainty and the misty supposition of space – as if we were stuck in the Enterprise's transporter in a faulty energise.

Now if Martin Wheatley is laying claim to the mantle of Captain Kirk, Clive Adamson would be chief engineer Scotty. Based in the engine room of supervision, Adamson has to make it all work. Not for him what Spock would doubtless call the "fascinating" ideas of behavioural economics. For him, more practical issues. When he spoke on 19 April, he dwelt much on matters of culture. How to measure it and how the FCA will assess it. A great deal there is sensible, unsurprising and, above all, not new. Thus when considering firm culture, the FCA will be "joining the dots" and considering a "range of different measures," including "how the firm deals with regulatory issues… what customers are actually experiencing… how a firm runs its product approval… [and] the remuneration structures…"

Interestingly, Adamson is quite candid about the fact that the FCA doesn't "have direct rules about culture". But that won't stop them regulating it! As he says, "We don't directly supervise 'culture'… [but] we will… draw conclusions about a firm's culture and reflect that back to firms." And, unsurprisingly, they "will expect the firm to take account" of their views.

And what's wrong with that, you might ask? Isn't that what we've all been waiting for, a regulator unafraid to 'say it as it is' and to take people to task for malpractice? Well, it just depends on what you

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regard as malpractice. And that's where the various strands start to come together. Because the FCA doesn't want to define what malpractice might be, preferring to stay on the higher planes of moral rectitude. As Adamson said: "the cultural approach of doing the *right thing* has been lost for financial services…" and "the focus has been on ensuring compliance with a set of rules rather than doing the *right thing* for customers…"

So what is "doing the right thing"? Adamson points to JP Morgan chairman and CEO Jamie Dimon's letter to shareholders of 10 April. There, Dimon said that "most important" of JP Morgan's core values was to "treat our clients like you would a member of your own family. If you see a product feature you wouldn't feel comfortable selling to a relative, then we shouldn't be selling it to our clients, either."

That's all very well, but life – and financial services – tend not to be so simple. The major concern must be that the "right thing" is whatever the FCA wants it to be at any particular time, irrespective of what the rule book might or might not say or indeed whether you might disagree. (Have you recently been asked to meet with the FCA on what you thought was a contentious point and been told not to bring your lawyer? There's many that have been told as much. Because bringing your lawyer, arguing the toss, is not "doing the right thing…") And, as Wheatley has outlined, not doing the "right thing" may be doing something as previously innocuous as creating promotional material that, while fair, clear and not misleading, was on the wrong side of behavioural economics.

Overstated? Perhaps. But try asking senior FCA staff when they will be issuing further guidance on their expectations. When asked this question, Adamson raised his brows skyward, bemoaning the UK sector's "addiction" to guidance and said that the FCA would like to move away from such issuance. Wouldn't a smaller rule book be nice, he mused. Such a landscape would leave the FCA free to interpret what the "right thing" might be at any particular point in time, but it has negative consequences for the concepts of transparency and predictability that underpin the success and growth of the financial services sector as a whole.

Shortly after Adamson's speech, I bumped into a senior regulatory lawyer from a well-known London firm. We compared notes about where the FCA were. He said, "They're not quite settled yet – I think there's an element of making it up as they go along." Later, it dawned on me that this may be no accident – this may be the design. Thus, on the worst complexion, a reliance on "doing the right thing" and eschewing the issue of guidance leaves the FCA with a free hand, but leaves firms in a regulatory vacuum every bit as worrying as deep space.

Wheatley's predecessor on the bridge, Hector Sants, served as CEO for a five-year tour from 2007 to 2012. As Captain Kirk's own log records noted, he also had a 'five-year mission'. And we all know his task was "to explore strange new worlds, to seek out new life and new civilisations, to boldly go where no man has gone before…"

As Martin Wheatley settles into the captain's chair, he sets the good ship FCA on what indeed may be a new course. The phasers are set to stun and the photon torpedoes loaded. This may well be regulation, but "not as we know it". And the danger is, the FCA thinks we're all Klingons.

Julian Sampson *(julian@fulcrumcompliance.com) is director of Fulcrum Compliance (www.fulcrumcompliance.com) and chair of the Chartered Institute for Securities and Investment compliance professional forum.*

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