REGULATION OF MIS-SELLING OF OVER-THE-COUNTER DERIVATIVES: COMPARATIVE STUDY OF SOUTH KOREA AND THE UK

by

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ABSTRACT

The thesis analyses the conduct of business regulation ("COB") regime of South Korea in comparison with the UK regime and assesses how well the COB regimes of the two countries have achieved the regulatory objective of preventing over-the-counter derivatives 'mis-selling'.

The thesis conducts a comparative study in three regulatory areas of the COB regimes: rule-making, rule-enforcing and private enforcement. In terms of rule-making, the UK formulates its rulebook using various rule-types and this enables to build foundation to satisfy both stability and rationality; South Korea, due to constitutional, political and historical constraints, creates a rulebook with only precise and clear rules, which, as a result, is one of the causes for the overall COB regime's rigid legalism.

In rule-enforcing, the UK relies on the goodwill of the regulated firms and selects the compliance-focused enforcement approach but in the end, such a soft enforcement strategy has failed in achieving the regulatory objectives. South Korea's deterrence-focused enforcement has produced regulatory failure that the regulator as well as the regulated firms focus on the letters of rules instead of the regulatory objectives.

In private enforcement, in the UK, the dissonance between the principles of private law and the COB in dealing with mis-selling of derivatives sometimes results in confusing situations where an action is subject to sanctions under the COB but not recognized as a liability under private law. In South Korea, because the COB is binding on the courts, there is no dissonance between the COB standards and private law; rather, the court's approach of focusing on the substance of the COB requirements is complementing the regulator's process-focused enforcement.

Based on the comparative study, the thesis recommends for the UK to harmonize private law with the COB by placing the COB as the minimum requirement of private law. For South Korea, its recommendation is to shift the whole regulatory system from command and control style to the decentred one.

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LIST OF ABBREIVATIONS

CESR	Committee of European Securities Regulators
COB	Conduct of Business Sourcebook
COBS	Conduct of Business Sourcebook
Core Rules	Core Conduct of Business Rules
CP	Commercial Paper
CPR 2014	Consumer Protection Amendment Regulations 2014
CSI	Credit Suisse International
CSUK	Credit Suisse UK Limited
DTI	Department of Trade and Industry
FCA	Financial Conduct Authority
FISCM Act	Financial Investment Services and Capital Markets Act
FOS	Financial Ombudsman Scheme
FSA 1986	Financial Services Act 1986
FSA 2010	Financial Services Act 2010
FSA 2012	Financial Services Act 2012
FSA	Financial Services Authority
FSS	Financial Supervisory Service
FSMA 2000	Financial Services Market Act 2000
JPMIB	JP Morgan International Bank
KIKO	Knock In, Knock Out
KFIA	Korean Financial Investment Association
IOSCO	International Organization of Securities Commissions
IRHPs	Interest Rate Hedging Products
ISDA	International Swaps Derivatives Association
LIBOR	London Interbank Offered Rate
LSTB	Lloyds TSB Bank
MiFID	Markets in Financial Instruments Directive
PCBS	Parliamentary Commission on Banking Standards
PCGID	Presidential Committee on Government Innovation and Decentralization
PFI Act	Prevention of Fraud Investment Act

PRA	Prudential Regulatory Authority
RBS	Royal Bank of Scotland
SE Act	Securities and Exchanges Act
SCARPs	Structured Capital-At-Risk Investment Products
SFA	Securities and Futures Authority
SIB	Securities and Investments Board Ltd.
SMCR	Senior Managers and Certification Regime
SRO	Self-Regulatory Organization
TCF	Treating Customers Fairly
Titan	Titan Steel Wheel
WRIR	Working Rules in Investment Recommendation

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I. INTRODUCTION AND FRAMEWORK OF THE RESEARCH

1.1 The research question and the problem it addresses

In South Korea, many small- and medium-sized enterprises ("SMEs") suffered substantial losses from currency-based over-the-counter derivatives, called KIKOs[1], during the global financial crisis. KIKOs had been widely promoted by Korean commercial banks prior to the crisis. As the crisis deepened in 2008, the Korean currency began to deteriorate against the US Dollar, contrary to the expectation of the SMEs. As a result, around 500 exporting SMEs, that had purchased KIKOs, incurred significant losses totalling around $3 billion. The SMEs filed civil suits claiming that KIKOs had been mis-sold, and the financial regulator investigated the KIKO sales process. However, the results were disappointing for the SMEs. In most cases, the court ruled that financial institutions that sold KIKOs didn't have the obligation to compensate for the losses. Similarly, the enforcement actions taken by the regulator were limited to low-level sanctions for minor breaches made by financial institutions.

After the KIKO scandal in South Korea, one of the main reasons identified for the occurrence of the mis-selling scandal was the lack of statutory regulation.[2] So the Financial Investment Services and Capital Markets Act ("FISCM Act") was enacted in order to raise the level of protection for financial investors. Much of what is in the section on Conduct of Business Regulation ("COB") in the Act was adopted from regulation in other jurisdictions like the UK which has a longer history of regulating financial markets. Korea also added its own stronger measures, not taken from any other country, to the FISCM Act. For example, the Act prohibits corporate and individual customers from over-the-counter derivative transactions for purposes other than hedging[3] and even in hedging, over-hedges are prohibited.[4] In addition, all newly designed over-the-counter

[1] KIKO (Knock-In Knock-out) contracts were advantageous to export trading companies as long as the US Dollar traded within a set range against the Korean Won, but resulted in huge losses to the purchasers if it appreciated beyond the specific range. As the Korean Won continued to strengthen against the US Dollar after 2006, the exporters' demand for KIKO contracts as hedge against foreign exchange rate risks increased.

[2] See section 3.2.3 and 3.3.3

[3] This means only investors who have underlying assets and liabilities can enter into over-the-counter derivatives only for avoiding risk of the underlying factors.

[4] See secton 3.3.3.3

derivatives must receive permission of sales from the industry association before they can be distributed.[5]

After the adoption of such a rigid regulation, the volume of over-the-counter derivatives transactions by financial institutions and SMEs dropped drastically and the percentage of export companies using over-the-counter derivatives for foreign exchange risk fell from 60% to 20%. Considering that over-the-counter derivatives may be more customized to fit each end-user's need,[6] compared to other means of hedging, the fall in the volume of transactions cannot be said to be a desirable regulatory outcome.

Over-the-counter derivatives have characteristics of both utility and high risk. When used well, they can be useful in hedging business risk efficiently, but they can also be a regulatory challenge because they have the following characteristics.

First, over-the-counter derivatives are more vulnerable to mis-selling than other financial instruments because of the significant informational asymmetry between consumers and sellers. While the financial services industry is notorious for information asymmetry,[7] the over-the-counter derivatives market is one of the worst areas even in the industry. Derivatives are unfamiliar products compared to other commonly transacted financial products like loans and insurance.[8] Consumers have limited knowledge of derivatives markets. Even large corporations' financial comptrollers who have substantial knowledge and experience in financial markets cannot understand the structure and risks of complex over-the-counter derivatives by themselves.[9] It is practically impossible for consumers, even corporate clients, to compare the price and other terms of non-standardized over-the-counter derivatives offered by different financial institutions.[10] Therefore, consumers

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[5] Ibid

[6] For instance, suppose a British company—which has receivables of $1.5 million from its foreign importer at the end of February—needs to hedge its foreign exchange rate risk. Exchange-traded derivatives such as futures and options may only reach maturity at the end of January and have a contract unit amount of $1 million. With such standardized derivatives, this company cannot fully hedge its foreign exchange rate risk due to the mismatch of maturity and amounts. Instead, over-the-counter derivatives can meet specific hedging needs through tailor-made bilateral aggrements.

[7] David Llewellyn, *The economic rationale for financial regulation* (Financial Services Authority, 1999) 25-26 available at <www.fsa.gov.uk/pubs/occpapers/op01.pdf> accessed 6th October 2017

[8] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation* (Oxford University Press 2011) 18

[9] For example, see n1324

[10] Robert E Litan, *The Derivatives Dealers' Club and Derivatives Market Reform: A Guide for Policy Makers, Citizens and Other Interested Parties* (Initiative on Business and Public Policy at Brookings 2010) 17

with insufficient information and knowledge have to rely on salespersons' explanations of over-the-counter derivatives.

Second, on the supply side, over-the-counter derivatives transactions are more lucrative for financial institutions compared to other generic financial products.[11] The attractive margins lead to pressure on salespersons to achieve high sales volume. This pressure isn't only business-driven, but also self-inflicted due to the personal sales-based compensation system[12]. The lucrative profit and generous personal compensation can create blindness[13] to the interest of consumers, if not opportunism.[14] The combination of the reliance and sales performance pressure makes over-the-counter derivatives more vulnerable to mis-selling.

Third, the size of losses from over-the-counter derivatives tends to be extensive. The leverage used by over-the-counter derivatives can cause losses significantly exceeding the investment principal and can even drive the investor into bankruptcy. In fact, many companies that incurred losses in South Korea ended up in bankruptcy. Thus, a mis-selling scandal involving over-the-counter derivatives can create a huge economic, social and political disturbance and so the failure to prevent or adequately manage such a scandal can greatly damage the public's confidence in the financial market. So, it is critical for the vitality and sustainability of the financial market to prevent extensive 'mis-selling' scandals of over-the-counter derivatives.

Then, considering the above characteristics of over-the-counter derivatives, the question raised is 'how can the regulation on mis-selling of over-the-counter derivatives successfully achieve its goal in South Korea?' In connection, the research objective of this thesis is to assess how well the South Korean COB regime has achieved the regulatory

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[11] Financial Crisis Inquiry Commission, and United States, Financial Crisis Inquiry Commission, *The financial crisis inquiry report: Final report of the national commission on the causes of the financial and economic crisis in the United States* (PublicAffairs 2011) 50

[12] See *Zaki & Others v CSUK* [2011] EWHC 2422 (COMM) where a sales person was compensated millions of pounds for selling structured notes to the plaintiff

[13] 'Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives' (1997) 22 *Del. J. Corp. L.* 197, 205

[14] Dan Awrey, 'Toward a supply-side theory of financial innovation' (n397) 23; Andromachi Georgosouli, 'The debate over the economic rationale for investor protection regulation: a critical appraisal' (2007) 15.3 *Journal of Financial Regulation and Compliance* 236, 239

objective of preventing over-the-counter derivatives 'mis-selling' and to suggest action plans to reform it.

In order to assess the COB regime, this thesis covers not only rule-making (law on the books) but also rule-enforcing (law in action). This comprehensive approach makes it possible to explore how the COB has evolved,[15] to identify how statutory rules have been made, to observe how the rules have been implemented in the front line, and to assess the regime in the jurisdiction's environment.[16] With this approach, the broader concept of law, not only the "law on the books" but also "law in action", can be linked to regulatory results.[17] A similarly comprehensive approach was applied by Berkow et al. regarding their investigation of investor protection in transition countries. In their research, they showed that the transition countries had well-developed law on the books for investor protection but poor enforcement, resulting in a low level of investor protection.[18]

This thesis seeks to provide practical guidance to the policymakers and the financial regulator in South Korea. [19] Thus it is an important goal of the thesis to derive normative and practical conclusions. To achieve this goal, the thesis adopts the comparative methodology analysing the COB regime of South Korea in comparison with the UK regime.[20] The comparative study of the two countries' COB regimes offers understanding of the nature of different regulatory strategies and finally identification of the resulting difference. Comparative study provides the insight which cannot be obtained by just

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[15] Zweigeret k and Kolz H, *An introduction to compa**ra**tive law (*Oxford University Press 1998) 15

[16] Eberle E, 'Comparative law' (2007) Roger Williams University School of Law Research Paper No.52 <http://ssrn.com/abstarct=1019051> Accessed 1/5/2013

[17] Pistor Katharina, Marting Raiser and Stanislaw Gelfer, 'Law and finance in transition economies' (2000) 8 Economics of Transition 325

[18] Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'Economic development, legality, and the transplant effect' [2003]

[19] Francesca Bignami, 'Introduction: A new field: comparative law and regulation' in Francesca Bignami and David Zaring, *Comparative Law and Regulation (*Elgar, 2016) 27, where the author explained that the domestic actors in charge of policy adoption are not 'core legal elites' but 'bureaucracies, political executives, and legislature'.

[20] For protection of financial consumers, one policy option is the empowerment of consumers but the large scale of losses sustained by households put questions on the effectiveness of this policy option. See also Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' in Eilís Ferran et al, *The regulatory aftermath of the global financial crisis* (Cambridge University Press, 2012) location 5021

analysing the South Korean regime on its own. Without a comparator, it is almost impossible to identify the causal relationship for certain aspects of regulation and their results.[21] Section 1.2 discusses more about why the comparative approach is valuable for the thesis.

The reason for selecting the UK as a comparator jurisdiction is that the two countries have 'controlled differences' in relation to COB.[22] Jansen said that comparative study can be seen as the social sciences' equivalent of experiments.[23] In an experiment, except for the variables for which the causal relationship is being tested, all other factors must be controlled.[24] In the '*experiment*' of this thesis, the effects of diverged approaches in rule-making and rule-enforcing of COB are being measured. In the area of COB, South Korea and the UK have big differences at the implementation level, but they share *'controlled'* similarities in regulatory objectives and governances.

The most important similarity is that both countries have the same problem of 'mis-selling' of over-the-counter derivatives, and so share the same regulatory objective to prevent it. The UK was another country where many SMEs incurred extensive financial losses in over-the-counter derivatives transactions; the over-the-counter derivatives in this case were interest rate hedge product ("IRHP").[25] The two countries experienced huge 'mis-selling' scandals of over-the-counter derivatives during the global financial

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[21] Geoffrey Wilson, 'Comparative legal scholarship' in Michael McConville and Wing Hong Chui (eds), *Research methods for law (*Edinburgh University Press 2007) 87; See also Gerhard Danneman, 'Comparative law: Study of similarities or differences?' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 398, where the author commented that *"even if comparative law cannot deliver full proof of a causal link between rule and effect, it can still produce more evidence for such a link than an enquiry which limits itself to one legal system"*

[22] Gerhard Danneman, 'Comparative law: Study of similarities or differences?' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 410

[23] Nils Jansens, 'Comparative law and comparative knowlegde' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 318

[24] Ibid

[25] The SMEs had entered into interest rate hedging products ("IRHPs") based on the financial institutions' recommendation to hedge against the expected rise of interest rates. However, when the Central Bank dramatically reduced the index interest rates after the financial crisis, this resulted in significant losses for the SMEs. Some of these SMEs sought compensation for their IRHP losses in court. At the same time, the financial regulator reviewed the IRHP sales practice and arranged for compensation to be paid to eligible SMEs but a number of SMEs applied for judicial review of the regulatory compensation process; see Financial Services Authority, 'FSA, Interest Rate Hedging Products: Pilot Findings' (2013) available at <www.fsa.gov.uk/pubs/other/interest-rate-swaps-2013.pdf> 6th October 2017

crisis and so share the experience of their public and private legal systems handling the scandals.[26] Both countries have an open and mature economy where many SMEs and individual investors have the need to invest in or hedge with over-the-counter derivatives. For comparative research, the compared jurisdictions must have commonality in their issues and policy goals,[27] as Zweigert and Koz argued.[28]

As the second similarity, the two countries have similar financial regulatory governances although they operate under different legal origins of the civil law and common law systems.[29] In both countries, the mechanisms of how COB operates within the legal system are similar. For example, financial regulation, which is a branch of public law, intervenes in transactions of financial instruments, which have traditionally been the domain of private law, by imposing obligations on financial institutions in terms of the contractual relationship between sellers and buyers.[30] Regarding breaches of financial regulation, both countries have two enforcement tools: public sanction by the regulator and private action by aggrieved consumers.[31] In addition, in the year 2000, South Korea benchmarked the UK's single regulator set up via the FSMA 2000 and changed to a consolidated single financial regulator. South Korea also referenced the UK's Financial

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[26] See p 1 for KIKO scandal in South Korea and p 5 for IRHP scandal in the UK. In the UK, interest rate hedging products ("IRHP"), a type of over-the-counter derivatives, resulted in extensive financial losses among many small and medium-sized enterprises. Some of these enterprises sought compensation for their IRHP losses in the courts. At the same time, the financial regulator reviewed the IRHP sales practice and arranged for compensation to be paid to eligible end-users. However, despite land-mark rulings from the courts and a regulator-led compensation programme, a number of SMEs applied for judicial review of the regulatory compensation process.

[27] Ralf Michaels, 'The Functional Method of Comparative Law' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 367

[28] Konrad Zweigert and Hein Kotz, *An Introduction To Comparative Law* (Oxford University Press, 1998) stating that "[d]ifferent legal systems can be compared only if they solve the same factual problem, that is, answer the same legal need. In other words, the institutions of different legal systems can be meaningfully compared only if they perform the same task, if they serve the same function."

[29] Konrad Zweigert and Hein Kotz, *An Introduction To Comparative Law* (Oxford University Press, 1998) 315-328

[30] Giuseppe Bellantuono, 'Contract Law and Regulation' in P. Monateri (ed.), *Handbook of Comparative Contract Law (*Elgar Pub., 2015); Olha O. Cherednychenko, 'Public Regulation, Contract Law, and the Protection of the Weaker Party: Some Lessons from the Field of Financial Services' [2014] 22.5 European Review of Private Law, 663; see also Hans-W. Micklitz, 'Regulatory Strategies on Services Contracts in EC Law' (2008) EUI LAW Working Paper No. 2008/06, available at SSRN: <https://ssrn.com/abstract=1093643> accessed 23rd June 2017

[31] See chapter VI and V for detail about enforcement

Services and Markets Act ("FSMA") 2000 and related statutory regulation in making the COB of the FISCM Act.[32] Thus two countries' COB requirements are conceptually very similar.

However, at implementation level, the COB regime on 'mis-selling' of financial instruments significantly differs between the two countries. South Korea's rule-making is rule-based and enforcement is oriented toward deterrence, whereas the UK's rule-making is principle-based and enforcement is compliance-focused.[33] Although both countries have the same regulatory goal of preventing 'mis-selling', the different implementation strategies are creating very different results. Therefore, a comparative study of the two countries provides good observation opportunities about the results of different approaches in rule-making and rule-enforcing, as Levi argued that only with variations can associations between variables and outcomes be established.[34]

The diverging implementation approaches in the two countries can be connected to their different legal origins. Ogus explained that countries of common law and civil law system have different approaches to conferring power and discretion on regulatory agencies and rendering them accountable.[35] Thus, Siems advises a comparative research choosing legal systems which are neither too similar nor too different, such as a civil law and a common law country with the similar societal development level.[36] His point was that comparing too similar or too different legal systems doesn't produce meaningful findings: uninteresting result or comparisons between "apples and oranges". Based on Siems' argument, South Korea and the UK, which have different legal origins but share similar regulatory goals and governances, are a good basis for comparative research.

In order to achieve the research objective based on comparative analysis, the following five key questions are raised:

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[32] Ministry of Finance and Economy, 'Explanation Material on FISCM Act Bill' (2006)
[33] See chapter III and IV
[34] David Levi-Faur, *Handbook on the Politics of Regulation* (Edward Elgar Publishing, 2011) 178
[35] Anthony Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' (2004) *Leading Issues in Competition, Regulation and Development*,146, 160
[36] Mathias Siems, *Comparative Law (*CAMBRIDGE Universtiry Press, 2014) 15-16

1) **What are the characteristics of over-the-counter derivatives which make them more vulnerable to "mis-selling" than other financial instruments?**

2) **What theoretical frameworks does this thesis use in conducting the research?**

3) **What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?**

4) **How did South Korea and the UK design the relationship between private law and the COB and as a result, do public enforcement and private enforcement interplay effectively in the COB regimes of the two countries?**

5) **What reforms are needed to improve the effectiveness of COB regimes of South Korea and the UK?**

1.2 Methodology employed to answer the research questions

The research questions 3) to 5) are examined within not one but two distinct theoretical frameworks and literatures. It uses both comparative law research and regulatory theory to examine the regimes of South Korea and the UK in order to seek practical answers to a series of issues that arise in relation to the effectiveness of COB. These issues encompass substantive rule-making and design, implementation and enforcement of rules in each of the two jurisdictions. The question of effectiveness is first and foremost in all of these discussions and so the conceptualisation of effectiveness and how it is benchmarked is important, which is described in depth in section 1.3.2 based on regulatory theory.

Regulation being a cross-disciplinary field of study related to law, politics, and economics, it cannot be investigated by a dominant framework from any one discipline.[37] Moreover,

[37] Ibid

without practical guidance, the principles for 'better regulation' may contradict each other.[38] And so if only a purely theoretical approach is employed in looking at how the rules should be framed and enforced, there can be limitations to identifying an effective regulatory strategy. Thus, an evidence-based approach is needed. Advice on how to formulate rules and enforce them can be practical only when it is founded on specific cases.[39] Thus, the thesis employs a comparative study of important practical aspects of two COB regimes, the UK and South Korea. However, just comparison alone isn't enough to find 'better regulation'. The thesis employs theoretical insights drawn from regulatory theory about rule-design and enforcement strategies in order to evaluate the effectiveness of these regimes.[40]

The thesis analyzes the COB regimes of South Korea and the UK based on comparative methodology and regulatory theory, and the findings of the thesis are as follows:

1) ***Rule-making:*** The UK formulates its rulebook using various rule-types such as Principles, Rules and Guidance and this enables the COB regime to be able to build foundation to satisfy both stability and rationality; South Korea, due to constitutional, political and historical constraints, creates a rulebook with only precise and clear rules, which, as a result, is one of the causes for the overall COB regime's rigid legalism.

2) ***Rule-enforcing:*** The UK relies on the goodwill and capability of the regulated firms and selects the compliance-focused enforcement approach but in the end, such a soft enforcement strategy based on one-way trust has failed in internalizing the regulatory objectives into the firms' norms. South Korea's deterrence-focused enforcement has produced regulatory failure in that the

[38] Christopher Hood, *The Government of Risk: Understanding Risk Regulation Regimes (*OUP Oxford, 2001) 180; see also Robert Baldwin, Christopher Hood, and Henry Rothstein, 'Assessing the Dangerous Dogs Act: when does a regulatory law fail?' (2000) *Public Law*, 282, 300

[39] Edward J. Eberle, 'Comparative Law' (2007) 12 available at <http://ssrn.com/abstract=1019051> accessed 9th August 2017

[40] Konrad Zweigert and Hein Kotz, *An Introduction to Comparative Law* (Oxford University Press, 1998) 24; see also Francesca Bignami (n19) 14

regulator as well as the regulated firms focus on the letters of rules instead of the regulatory objectives.

3) ***Private enforcement:*** In the UK, there is dissonance between the principles of private law and the COB in dealing with mis-selling of derivatives. Because the court adjudicates based on the principles of private law, this sometimes results in confusing situations where an action is subject to sanctions under the COB but not recognized as a liability under private law. In South Korea, because the COB is binding on the courts, there is no dissonance between the COB standards and private law. Rather, the court's approach of focusing on the substance of the COB requirements is complementing the regulator's standardized enforcement which is more focused on procedural requirements.

4) ***Recommendation:*** In the UK, one of the biggest causes for regulatory failure is the defective culture in the financial services industry, and the dissonance of orders between private law and COB contributes to the defective culture. The recommendation for the UK is to harmonize the dissonant orders by placing the COB as the minimum requirement of the private law. For South Korea, the recommendation is to shift the whole regulatory system from command and control regulation to decentred regulation. For this fundamental reform, the establishment of a cultural infrastructure based on the regulatee's and the regulator's professionalism and cooperative partnership is critical.

1.3 Theoretical frameworks applied in the thesis

The section provides explanation about the comparative law applied in analyzing the COB regimes of South Korea and the UK and the regulatory theory used as the basis for evaluating the two regimes. This section provides the answer to the second research question.

1.3.1 Theoretical frameworks of comparison

1.3.1.1 Comparative law and its purposes

In the simplest terms, comparative law can be said to be a way of looking at law.[41] Kahn-Freund's explanation of comparative law is that it is a methodology for understanding foreign law including the entire legal system, institutions and rules, and involving the juxtaposition and contrast of findings and comparisons in order to identify similarities and differences.[42] In this sense, the comparative method is both an empirical and descriptive research method. [43]

Among the multiple purposes of comparative law,[44] its purpose in the thesis is to provide "law reform and policy development" in the regulation of derivatives 'mis-selling'.[45] Orucu argued that comparative law research can provide a list of models to choose from,[46] and that policy-makers can derive answers by comparing systems which share the same problem but deal with it in "better ways".[47] The following sections discuss how to find 'better ways' through comparative law.[48]

1.3.1.2 Methodology of comparison

Samuel stressed that posing the proper question for comparative legal study, like any research, is critical for its success.[49] One of the most important points in formulating questions, according to him, is that the reason why a comparative approach is fundamental should be built into the research question.[50] Thus the answers to the research questions should be able to be obtained only "through bringing together

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[41] Esin Orucu, 'Developing comparative law' in Esin Orucu and David Nelken (eds.), *Comparative law: A handbook* (Bloomsbury Publishing, 2007) 45

[42] Ibid

[43] Ibid 48

[44] Esin Orucu, 'Developing comparative law' (n41) where the author presented the five purposes of comparative law: law reform and policy development for the legislator, aid to the international practice of law, international harmonization and unification, common core research, and a gap-filling in law courts.

[45] See the section 1.2

[46] Esin Orucu, 'Developing comparative law' (n41) 54

[47] Esin Orucu, *The enigma of comparative law: variations on a theme for the twenty-first century*, (Springer, 2013) 14-20

[48] See section 1.3.1.2

[49] Geoffrey Samuel, *An introduction to comparative law theory and method* (Vol. 11. Bloomsbury Publishing, 2014) location 759 (kindle edition)

[50] Ibid

objects of comparison".[51] The reason why this thesis chooses a comparative method was explained in section 1.2.

Orucu advised that formulating questions is related to concept building; the concept should not be so broad as to be meaningless nor too narrow in coverage.[52] This thesis builds the concept: rule-making and rule-enforcing in COB regime for regulating 'mis-selling' of derivatives. The concept built here is "flexible and large enough to embrace heterogeneous legal institutions" of South Korea and the UK.[53]

After posing the question, the researcher should describe, juxtapose, and identify similarities and differences.[54] He should begin with facts and end in description. Similarities and differences brought to light by the comparison are then identified.[55] Here, it should be clear as to what compared. Orucu answered that the traditional approach is of a positivist: statutory rules, case law and pertinent legal documents, but that law goes far beyond the so-called 'official law' and extends to "multi-layers of systems".[56] He stressed that statutory rules alone cannot be the object of comparative research,[57]but that what the researcher should compare, as *tertium comparasonis*, is "common function between institutions and rules, the common goal they set out to achieve, the problem to solve".[58] He added that *tertium comparasonis* is a flexible choice about which aspects of the law might benefit from the additional knowledge from comparison.[59] As to the object of comparison, this thesis encompasses not only rule-making but also rule-enforcing. Different approaches of rule-enforcing even with the same rules may produce different results, and so rule-enforcing is the aspect of law which can benefit from comparison.

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[51] Ibid

[52] Esin Orucu, 'Developing comparative law' (n41) 48

[53] Konrad Zweigert, Hein Kötz and Tony Weir, *Introduction to comparative law* (Oxford: Clarendon Press, 1998) 43, where the authors explain this as to "build a system".

[54] Nils Jansens, 'Comparative law and comparative knowlegde' (n23) 309

[55] Gerhard Dannemann, 'Comparative law: study of similarities or differences' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 399

[56] Esin Orucu, 'Developing comparative law' (n41) 60

[57] Ibid

[58] Ibid 47

[59] Nils Jansen, 'Comparative law and comparative knowledge' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 313

After identifying similarities and differences, the researcher ventures into the task of explanation.[60] Jansen argued that the explanation for differences and similarities needs not only legal reasoning but also contextual factors which explain why the legal systems have produced the institutions they have.[61] For this, Orucu contended the need for a contextual approach in analyzing rules and institutions, such as "historical context", "political context" and "cultural context".[62] Ideally, macro- and micro-comparison should merge, since the micro-comparative topic must be placed within the entire legal system.[63] Enrlich argued that the researcher must understand the relationship between legal systems and legal cultures as well as find rules that are not necessarily within the formal framework of the legal system but are held by the society.[64] He added that legal culture has substantive influence on the operation of the legal institution via the users' attitudes, beliefs and emotions. So, he defined legal culture as the center of gravity of legal developments; something which doesn't lie in legislation but in society itself.[65] Under this broad approach, the researcher should move away from the 'law as rules' attitude because law cannot be understood properly unless it is explained within broad historical, political and socio-economic contexts.[66] The thesis, in explaining the differences between the COB regimes of the two countries, considers the legal tradition, political and economic contexts. How these factors influence the shaping of COB regimes is discussed in section 1.3.2.4.

Functional method

The thesis adopts functionalism as the comparative methodology for analyzing the COB regimes of South Korea and the UK. According to Orucu, under the functional method, the researcher looks at a litigation problem in one system and having done this, she then

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[60] Nils Jansens, 'Comparative law and comparative knowlegde' (n23) 309-313
[61] Ibid; see also Esin Orucu, 'Developing comparative law' (n41) 48
[62] Esin Orucu, 'Developing comparative law' (n41) 52
[63] Geoffrey Samuel, *An introduction to comparative law theory and method* (Vol. 11. Bloomsbury Publishing, 2014) location 1266
[64] Eugene Ehrlich and Klaus A. Ziegert, *Fundamental principles of the sociology of law* (Routledge, 2017) ch XV
[65] Ibid
[66] Henry Walter Ehrmann, *Comparative legal cultures* (New Jersey: Prentice-Hall, 1976) 9

asks how such a problem would be solved in another legal system.[67] Michaels explained that a functional method focuses not on the rules but their effects and not on the doctrinal structures but the events and so as a result, the object of research is the judicial decisions made to address the situations in the real world.[68] In the thesis, the public and private enforcement cases can be seen as the case law and judicial decisions referred to by Orucu and Michaels.

Thus, the functional method focuses on the facts of cases and so is a "bottom-up" approach.[69] Gerber argued that the analysis of comparative law should start at the problems themselves and that such an approach enables a meaningful comparison.[70] He continued that the objective of the functional method is to understand how rules operate and so rules should be studied in connection with a specific problem rather than solely as the central object of the study.[71]

Therefore, for the functional method to be applied, the social needs and the problems identified must be universal.[72] In other words, if a problem arises in one legal system but has no counterpart in another, this method can reveal nothing.[73] In the context of the thesis, a comparison of regulation on derivatives mis-selling will be meaningless if done with societies where derivative transactions are not active. Michaels highlighted this point by explaining that societies should be in similar stages to have a meaningful comparison.[74] One of the reasons that the thesis selected South Korea and the UK as comparator jurisdictions is because they have the similar economic environment that necessitate over-the-counter derivatives transactions and so there is the common issue of 'mis-selling'.[75]

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[67] Esin Orucu, 'Developing comparative law' (n41) 50
[68] Ralf Michaels, 'The functional method of comparative law' (n27) 341
[69] Geoffrey Samuel, *An introduction to comparative law theory and method* (Vol. 11. Bloomsbury Publishing, 2014) location 1821
[70] David J. Gerber, 'Sculpting the agenda of comparative law: Ernst Rabel and the facade of language' (2001) 190, 190 available at: http://scholarship.kentlaw.iit.edu/fac_schol/247 accessed on 30th September 2018
[71] Ibid 200
[72] Ralf Michaels, 'The functional method of comparative law' (n27) 367
[73] Esin Orucu, 'Developing comparative law' (n41) 52
[74] Ralf Michaels, 'The functional method of comparative law' (n27) 370
[75] See p 5

Finding better law

As the final step in comparative research, Zweigert and Kötz argued that the researcher should be interested in suggesting the way to 'better law'.[76] However, searching for 'better law' should involve the process of evaluation.[77] Michaels argued that it isn't easy for comparative legal research to move from fact to norm,[78] because comparative material cannot provide guidelines about 'better law' and even the commonality of laws cannot have normative force for it.[79] Orucu also pointed out that the legitimacy of using comparative law to search for 'better law' is questionable.[80] These arguments mean that just identifying differences and explaining the causes cannot provide sufficient rationale to choose one as 'better law'.

Michaels argued, considering the above limits of the functional method, that the criteria of evaluation should be placed outside the function itself, such as "costs of an institution".[81] He continued that evaluation should belong to the area of the policy decisions and be a practical judgement under partial uncertainty.[82] He concluded that the functional method can improve the quality of policy decisions by providing alternatives and information.[83] Based on Michaels' argument, the thesis chooses "effectiveness" as the criteria of evaluation of COB regimes in the two countries, which is "outside the function" of COB. How to define and evaluate effectiveness of COB is discussed in the next section.

1.3.2 Theoretical framework of evaluation

In order to evaluate the effectiveness of COB regimes, the objective of COB should be clarified first. As financial instruments traded in the capital markets become more

[76] Konrad Zweigert, Hein Kötz and Tony Weir, *Introduction to comparative law* (Oxford: Clarendon Press, 1998) 45
[77] Esin Orucu, 'Developing comparative law' (n41) 49; see also Mathias Siems, *Comparative Law (*CAMBRIDGE Universtiry Press, 2014) 22-23
[78] Ralf Michaels, 'The functional method of comparative law' (n27) 373-375
[79] Ibid
[80] Esin Orucu, 'Developing comparative law' (n41) 49
[81] Ralf Michaels, 'The functional method of comparative law' (n27) 374
[82] Ibid 374-375
[83] Ibid

complicated, dependence of consumers on financial institutions has deepened, which makes the relationship between the consumer and financial institutions somewhat fiduciary in nature.[84] One of the main objectives of COB is to mitigate the agency problem originating from the intermediary-client relationship.[85] In order to prevent intermediaries from abusing the trust of consumers, COB prescribes duties of financial institutions. Such centrally prescribed duties are rationalized because they reduce the transaction costs which otherwise individual consumers should bear to design specific contractual provisions for their own protection.[86] However, this aspect of COB protecting idiosyncratic consumers with generic requirements poses difficulties in finding tailor-made solutions for each consumer.[87] For some consumers with sufficient experience and resources, the requirements for investor protection placed by COB are not only unnecessary but obstacles in their investment. One of the devices to solve this issue in COB is the consumer classification system.[88] But this broad classification system which categorizes the whole population of consumers into three groups such as eligible counterparties, professional clients and private customers isn't detailed enough to differentiate each consumer's diverging knowledge and circumstances. Therefore, how to provide the proper level of protection to each consumer is one of the most challenging issues in COB regimes.

The approach to achieving the COB's objective of providing a proper level of protection to each consumer can diverge. One extreme is to define detailed procedural requirements on transactions of over-the-counter derivatives and to enforce them stringently. This approach can make regulatory actions predictable but may damage the reasonableness of the actions. The other extreme is to set a broad and vague regulatory goal in a rulebook and to focus on supporting the regulatee to achieve it. This approach

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[84] Alessio M. Pacces, 'Financial intermediation in the securities markets law and economics of COB' (n402) 482; Mads Andenas and Iris HY Chiu, *The foundations and future of financial regulation: Governance for responsibility* (Routledge, 2013) 25

[85] Ibid

[86] Frank H. Easterbrook and Daniel R. Fischel, 'Contract and fiduciary duty' [1993] 36.1 *The Journal of law and economics*, 425

[87] John Armour, *Principles of Financial Regulation (*Oxford University Press, 2016) location 7985

[88] Financial Services Authority, Customer Classification (Consultation Paper 43, 2000)

may enhance the reasonableness of regulatory actions but can deteriorate predictability and certainty.

Effectiveness of regulation as a benchmark for jurisdictional comparison

Yeung saw regulatory effectiveness as a collective concept, a "cluster of goals" such as clarity, predictability, flexibility, and responsiveness, which may compete with each other.[89] She implies that pursuing one regulatory goal may come at the sacrifice of another regulatory goal.

A regulatory regime generally pursues two values, each of which is a cluster of goals stated above.[90] The first is stability.[91] Stability means that the regulatee should be able to have clarity and predictability about regulatory intervention. For this, a regulatory regime should explain what activities are permitted and what are not in advance.[92] In addition to clarity, the consequences of conducting non-permitted activities should be predictable.[93] Then the regulatee can plan their activities for the future and pursue their interests within the permitted boundaries. Regulation can provide benefits not only from regulatory interventions but also from the regulatee being able to plan their behaviours.[94] A regulatory regime with insufficient clarity and predictability may deter socially desirable activities.[95] In the context of COB, stability will be enhanced when financial institutions can clearly understand what products and marketing methods are permissible by COB.

The other regulatory value is rationality.[96] Rationality means regulatory actions should be flexible in achieving the purpose of the regulation and responsive to the changing

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[89] Karen Yeung, *Securing compliance: A principled approach* (Bloomsbury Publishing, 2004) 31;
[90] Ibid 30-36
[91] Ibid 33
[92] Nicola Lacey, 'The jurisprudence of discretion: escaping the legal paradigm' (Clarendon Press, 2002) 361-363; see also James Q. Wilson, *Bureaucracy (*Basic Books, 1989) 335
[93] Ibid 361-363
[94] Karen Yeung, *Securing compliance: A principled approach* (n90) 33-34
[95] John Armour, *Principles of Financial Regulation (*Oxford University Press, 2016) location 18707-18747 (kindle edition)
[96] William F. West, *Administrative Rule-making: Politics and Processes (*Greenwood Press, 1985) 189-195

environment.[97] Legal formalism often ignores the substance of regulation by adhering to letters of rules,[98] and thus inevitably brings about blind adherence to letters of the law and failure to achieve what rules target.[99] Flexible regulatory action allows the spirit of a rule to be realized. Responsiveness in a regulatory regime is its adaptability to the changing environments.[100] Rule-makers cannot anticipate all the contingencies of the future; thus, current rules can be useless or counter-effective in achieving the policy goal in situations that were not anticipated. In the context of COB, rationality means that rules should be made and enforced in a way to ensure that the ultimate regulatory objective is achieved, or in other words, increasing consumers' welfare by preventing 'mis-selling'.

The foregoing explains that a regulatory regime should pursue both the values of stability and rationality. It can be said that stability can be enhanced by precise rules while rationality by discretion. The dilemma is that the two regulatory values are in many cases contradictory.[101] Stressing stability of a regulatory regime can work in an opposite direction to rationality of the regime, and vice versa.[102] Both regulatory values are important for the welfare of society; thus, it is important to remember that a trade-off relationship exists between them.[103]

The trade-off relationship between stability and rationality exists in the COB regime too.[104] Therefore, the thesis defines the effectiveness of the COB as how well the two contradictory values are balanced in rule-making and rule-enforcing.

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[97] Karen Yeung, *Securing compliance: A principled approach* (n90) 33-34

[98] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) 25

[99] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (Transaction Publishers, 1982) Ch III

[100] Karen Yeung, *Securing compliance: A principled approach* (n90) 34-35

[101] William F. West, *Administrative Rule-making: Politics and Processes (*n96) 15-31; see also James Q. Wilson, *Bureaucracy (*Basic Books, 1989) 315-332

[102] Philip Rawlings, Andromachi Georgosouli and Costanza Russo, 'Regulation of financial services: Aims and Methods' (2014) *Queen Mary University of London, Centre for Commercial Law Studies*, 36

[103] Ibid; Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) 27; Colin Scott, 'Standard-Setting in Regulatory Regimes' (April 16, 2009) 9-12 University College Dublin Law Research Paper No. 07/2009, available at <SSRN: https://ssrn.com/abstract=1393647> accessed 8th December 2016

[104] Emma Gibson et al., 'Effectiveness of Regulation: Literature Review and Analysis' (2008) 9 available at http://publications.environmentagency.gov.uk; see also Frank Partnoy, 'Financial systems, crises, and regualtion' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) where the author said "[t]he complexity of modern markets has led

Cause of the trade-off relationship

The trade-off relationship between *stability* and *rationality* is deeply related to the rules' limitations.[105]

The most commonly known function of rules is to enable control over the extent of discretion the governmental officials can have in executing administrative actions.[106] Davis argued that most of the injustice in government interventions is due to officials relying on discretion instead of rules and that such discretionary power should be restricted through rules.[107] Rules prevent abusive discretion by ensuring consistent government intervention, irrespective of time or subject. In addition, because rules can provide the criteria needed for decision-making, they can prevent mistakes and regulatory capture in decision-making.[108]

However, rules are not perfect. Limitations that rules have in relation to administrative decision-making can be summarized as inclusiveness and indeterminacy.[109] Rules' tendency of under- or over-inclusiveness stems from the nature of rules, and rules' indeterminacy comes from the nature of the language which describes rules.[110]

Inclusiveness

Inclusiveness is about how completely a rule includes all characteristics of the regulated actions relevant to the policy goal. Rule-making must go through a process of generalization where the characteristics of regulated actions are categorized; then, the characteristics which have cause-effect relationships with the relevant policy goal are

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to the proliferation of ex-ante rules, which purport to provide greater certainty to regulators and market participants. In some cses, that certainty is important and welcome. In other cases, it has deleterious consequences. The proliferfation of ruels raises numerous policy questions, including whether financial markets might be better served by greater regulatory uncertainty."

[105] Karen Yeung, *Securing compliance: A principled approach* (Bloomsbury Publishing, 2004) 30-36

[106] For example, Kenneth Culp Davis, 'Discretionary justice' (1970) 23.1 *Journal of Legal Education* 56; William West, 'Administrative rule-making: An old and emerging literature' (2005) 65.6 *Public Administration Review* 655, 655; Paul Craig, *Administrative Law (*Sweet & Maxwell, 8th edition, 2016) Ch I

[107] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) 219

[108] Robert Baldwin, *Rules and government* (Clarendon Press, 1995) 13

[109] Robert Baldwin, *Rules and government* (n108); Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997); Frederick Schauer, *Playing by the Rules: A Philosophical Examination of Rule-based Decision-making in Law and in Life* (Clarendon Press, 1991)

[110] Robert Baldwin, *Rules and government* (n108) 6

filtered out.[111] However, assessing the cause-effect relationship involves anticipating future events which can result from the characteristics and this inherently has the possibility of errors.[112] Realistically, it is impossible to design rules with perfect inclusiveness.[113] If the relevant technology or practice of actions is rapidly changing, cause-effect estimates are even more difficult. Pistor and Xu argued that law inherently cannot help but be over- or under- inclusive.[114] They explained that because law has to cover a large variety of cases over a long period of time, it must be generally defined and cannot be designed to address every event; thus, law is highly likely to be over-inclusive.[115] But if detailed action types are specified in law in order to reduce over-inclusiveness, they argued, the law can be under-inclusive because lawmakers cannot accurately foresee all future events.[116]

Ehrlich and Posner commented that over- and under-inclusive rules are both ineffective.[117] Over-inclusive rules hinder socially beneficial actions.[118] Under-inclusive rules allow actions which should be socially forbidden and so reduce society's welfare.[119] Over-inclusive rules, in addition to the direct loss resulting from the diminishment of beneficial actions, trigger uncooperative attitude among the regulatees.[120]

Indeterminacy

Another inherent limitation of rules is indeterminacy.[121] Indeterminacy first arises because of the 'nature of language'. Hart explained that, when interpreting meaning, the general

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[111] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 7
[112] Ibid
[113] Frederick Schauer, *Playing by the Rules: A Philosophical Examination of Rule-based Decision-making in Law and in Life* (Clarendon Press, 1991) 35
[114] Katharina Pistor and Chenggang Xu, 'Incomplete law' (2002) 35 *NYUJ Int'l L. & Pol*, 932, 941-944 where he used different terminology of Type I (over-inclusive rules) and Type II (under-inclusive rules); see also Christopher Hood, *The Government of Risk: Understanding Risk Regulation Regimes (*OUP Oxford, 2001) 181
[115] Ibid
[116] Ibid
[117] Isaac Ehrlich and Richard A. Posner, 'An economic analysis of legal rule-making' (1974) 3.1 *The Journal of Legal Studies* 257
[118] Ibid
[119] Ibid
[120] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (n99)*;* Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 9
[121] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 10

language which constitutes rules is divided into two parts: 'a core of certainty' and 'a penumbra of doubt'.[122] Hart gave the example of the 'vehicle': it is clear that the motor car is included in the idea of a vehicle ('a core of certainty') but it is unclear whether roller skates are included ('a penumbra of doubt'). He explained that 'there is a limit, inherent in the nature of language, to the guidance which general language can provide'.[123] As such, the 'penumbra of doubt' must be clarified through interpretations in each case.[124]

Black suggested that interpretation of rules has limitations as well. The meaning of the general language used in rules can vary depending on the community using them.[125] A word that has a particular meaning in one community can have a different meaning in another. The interpretation of general language in a rule can vary depending on what is agreed by the community.[126] Thus, the meaning of a rule doesn't have one accurate interpretation. It can be said that the certainty of a rule relies not only on the characteristics of the rule itself but also on how much the constituents in the regulatory space have a common understanding of the rule.

Regulation by rules or by discretion

Regulating by rules seeks to build processes in administrative actions in order to protect individuals' procedural rights.[127] However, the justice pursued only by rules tends to focus on procedural fairness instead of substantive results.[128] Because of the rules' limitations discussed above, it is impossible for rules to perfectly define the policy goal ex-ante.

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[122] Herbert Lionel Adolphus Hart et al., *The concept of law* (Oxford University Press, 2012) 123
[123] Ibid125
[124] Ibid 124-128
[125] See Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 17
[126] Stanley Fish, *Doing What Comes Naturally: Change, Rhetoric, and the Practice of Theory in Literary & Legal Studies* (Duke University Press, 1989) location 1719 (Kindle edition)
[127] Robert Baldwin, *Rules and government* (n108)18
[128] Nicola Lacey, 'The jurisprudence of discretion: escaping the legal paradigm' in Keith Hawkins, *The uses of discretion (*Clarendon Press, 2002) 369

On top of this, it isn't even clear that rules can control abusive discretion by officials.[129] Because regulatory officials are the experts in regulatory processes, they can find many ways to justify their actions or non-actions. Thus, the attempt to limit an official's discretion by increasing the number of rules and making the rules more detailed may not achieve the intended effect. Rather, some commentators empirically showed that internalized social obligations are more effective in acting as constraints to officials' decision-making.[130]

Regulation only relying on rules sees administrative decision-making as applying a mechanical formula, 'if A (a situation when regulatory intervention is needed), then B (a regulatory intervention)'.[131] However, defining situations where regulatory intervention is needed, or in other words the 'A' in the formula, isn't something that can be done mechanically in the real world. Not only legal perspectives but also political perspectives impact the process of fact-finding. The IRHP scandal, where the UK parliament directly got involved in the regulator's investigation process is a good example.[132] In addition, even if the 'A' in the formula is defined, it cannot be said with certainty that the administrative action of 'B' will follow, because of selective enforcement.[133]

The slow responsiveness of rules is another problem in controlling discretion by rules. The world changes; thus, public and social demands also change. When rules cannot follow the speed of such changes, they act as a hindrance to adaptive regulatory decision-making.[134]

But then, regulation heavily relying on discretion is also far from perfection. In a democratic political system, the 'rule of law' is one of the means of ensuring that the

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[129] Robert Baldwin, *Rules and government* (n108)23

[130] Daniel J. Gifford, 'Decisions, Decisional Referents, and Administrative Justice' (1972) 37 *Law & Contemp. Probs.* 3, 5; Herbert Lionel Adolphus Hart et al., *The concept of law* (Oxford University Press, 2012) 141-142; Ronald M. Dworkin, 'The model of rules' (1967) 35.1 *The University of Chicago Law Review* 14, 32-40

[131] Isaac Ehrlich and Richard A. Posner, 'An economic analysis of legal rule-making' (n117) 258 ;Daniel J Gifford, 'Decisions, Decisional Referents, and Administrative Justice' (n130) 25-26

[132] See n188

[133] Donghua Chen, et al., 'Selective enforcement of regulation' (2011) 4.1 *China Journal of Accounting Research* 9

[134] David L Shapiro, 'The choice of rule-making or adjudication in the development of administrative policy' (1965) *Harvard Law Review* 921

government is 'responsive' to the people.[135] Rules with insufficient clarity and precision can be criticized as being undemocratic because the rights of the people are restricted by government officials who are not the representatives of the people.[136] There is the risk that discretion can unfairly intrude on individual rights at any time. Thus, Davis argued that discretion is a cause of government failures and that the scope and manner of usage of discretion should be clearly defined and limited through the usage of rules.[137]

In summary, this section defines effectiveness of regulation as balancing between stability and rationality and argues that a regulatory regime cannot reach the balancing point by rules or by discretion alone. The following sub-sections provide the theoretical framework for evaluating effectiveness of COB regimes of the two countries. First the approaches and strategies of rule-making and rule-enforcing are examined (theories to "identify differences") and then effective rule-making and rule-enforcing is defined; and the jurisdiction's diverging strategies in COB is explained (theories to "explain differences"); finally, the method of evaluating the effectiveness of COB is discussed (theories to "evaluate").

1.3.2.1 Different approaches to rule-making and its effectiveness

Rules can be classified into different types, and there are different approaches to formulating them. Each type has different effects on stability and rationality.

In classifying the types of rules, there can be various dimensions; here, coerciveness and precision will be used because they are closely related with this study.[138] Classifying a rule by coerciveness involves examining the effect when there is a contravention of the

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[135] Antonin Scalia, 'The rule of law as a law of rules' (1989) 56.4 *The University of Chicago Law Review* 1175, 1176; Eric A Posner and Adrian Vermeule, 'Inside or Outside the System?' (2013) *University of Chicago Law Review*, 1743, 1776-1778

[136] Antonin Scalia, 'The rule of law as a law of rules' (n135) 1176

[137] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* 142; see also Kenneth Culp Davis, 'Discretionary justice' (1970) 23.1 *Journal of Legal Education* 56, 58-61, where the author explained that 'open rules' were the best method to prevent 'arbitrariness' and 'injustice'. The 'openness' he argued for refers to the predictability and certainty of anyone being able to foresee the results.

[138] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 20-24

rule,[139] and based on this criterion, rules can be divided into mandatory rules and recommendatory ones. When there is a contravention of mandatory rules, there can be regulatory sanctions, but when there is a contravention of recommendatory rules, there is no direct legal effect. Recommendatory rules' function is to provide information on the regulation to improve compliance with mandatory rules. As mandatory rules provide the regulator and the regulatee with clear standards as well as clear consequences of a contravention, they strengthen the stability of the regulatory system. On the other hand, recommendatory rules improve the rationality of the regulatory system because the regulator uses discretion in deciding whether a contravention of the rule is inhibiting the achievement of the regulatory goal.

Classification by the level of precision of rules involves the extent of inclusiveness of rules.[140] There are various methods to turn a policy goal into rules from the precision criterion. The level of precision can be evaluated based on their literalness.[141] Precise rules have certainty in terms of their interpretation;[142] however, because of their rigidity, what they achieve can be somewhat distant from their purposes. For example, regarding the policy goal of preventing 'mis-selling', if a rule specifies each item that financial institutions must explain about a financial instrument, such as price, maturity and risk, anyone can decide with certainty whether there is a rule contravention. But if another information which isn't currently specified in the rule such as early exit fees becomes important for a financial instrument, then the rule becomes under-inclusive.

Less precise but more purposive rules provide flexibility for interpretation in a way which fits their purpose. Such flexibility enables the regulatees to have confidence that the application of rules is reasonable, thereby enhancing the cooperation between the regulator and the regulatee. However, the flexible interpretation may damage stability.[143] For example, if a rule requires financial institution to explain all *material information*

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[139] Margit Cohn, 'Law and Regulation: The Role, Form and Choice of Legal Rules' in David Levi-Faur, *Handbook on the Politics of Regulation* (Edward Elgar Publishing, 2011) 185-190

[140] Colin S. Diver, 'The optimal precision of administrative rules' (1983) 93.1 *The Yale Law Journal* 65, 66-68

[141] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004) n81 (Ch 8)

[142] John Armour, *Principles of Financial Regulation (*n95) location 18083 (kindle edition)

[143] Eilis Ferran, 'Capital Market Competitiveness and Enforcement' (2008) 8, available at <SSRN: https://ssrn.com/abstract=1127245> accessed 16th January 2017

about financial instruments, there can be flexibility in its application, and this approach is better aligned to the policy goal of preventing 'mis-selling'. However, the uncertainty of application increases because the meaning of *'material information'* can vary from person to person.

Effectiveness of rulemaking

Precise and mandatory rules can improve the certainty of their interpretation and application, but the rationality can be decreased in circumstances that were not foreseen at the time of rule-making. On the other hand, vague rules which directly express regulatory goals can be applied in accordance with their purposes; however, there is the greater possibility that consistency and certainty in rule-application will be deteriorated because of the reliance on discretion of rule-enforcers. The trade-off relationship between stability and rationality in rule-making has the implication that rule-making must strike a balance.[144]

The balancing point between the two values will vary depending on the characteristic of the regulated area and the attitude and culture of the regulatees. According to Pistor and Xu, vague rules are appropriate "in the area where institutional/technological change is comparatively slow and where the expected harm from actions that are not deterred can be contained" but "when actions may result in substantial harm that may not be easily reversed", vague rules may result in substantial loss in social welfare.[145] In determining which rule-types are appropriate for the COB requires an empirical approach based on an analysis of each rule-type's causality to regulatory outcomes.

In terms of rule-making, the regulatory costs (deterioration of certainty or deterioration of reasonableness) will vary depending on the type of rule due to the trade-off

[144] Isaac Ehrlich and Richard A. Posner, 'An economic analysis of legal rule-making' (n117); Colin S Diver, 'The optimal precision of administrative rules' (n140); See also Robert Baldwin, *Rules and government* (n108)

[145] Katharina Pistor and Chenggang Xu, 'Law enforcement under incomplete law: Theory and evidence from financial market regulation' [2002] 5-6 available at <http://eprints.lse.ac.uk/3748/1/Law_Enforcement_under_Incomplete_Law_Theory_and_Evidence_from_Financial_Market_Regulation.pdf> accessed 12th April 2017

relationship between stability and rationality.[146] Therefore, effectiveness of rule-making depends on how to successfully balance stability and rationality by using different types of rules.

1.3.2.2 Different approaches to rule-enforcing and its effectiveness

Different approaches in enforcement, even with the same standards, may create entirely different outcomes.[147] Reiss classified public enforcement strategies largely into two types.[148] One is compliance-focused enforcement, where regulatory resources are mostly put into compliance-supportive actions.[149] Under this strategy, ex-post sanction on a breach is only used as the last resort, while the educative and informative activities for preventing the breach are the main tasks.

The other approach is deterrence-focused enforcement, where sanctions against regulatory breaches are used to prevent further breach by the wrongdoer and other potential wrongdoers.[150] Much of the regulatory resource is put into the detection and sanctioning of breach. Under this approach, the relationship between the enforcer and the regulated is similar to that of the police and criminals.[151]

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[146] See p 1 8

[147] John C. Coffee, 'Law and the market: The impact of enforcement' 156.2 (2007) *University of Pennsylvania Law Review* 229, 284-292; see also Utpal Bhattacharya and Hazem Daouk, 'The world price of insider trading' [2002] 57.1 *The Journal of Finance* 75, where the authors showed that some countries which had prosecution of violators benefited the fall of capital cost among numerous countries which adopted the law against insider trading; see also See Viñals and Jonathan Fiechte, 'The Making of Good Supervision: Learning to Say "No"' (2010) *IMF STAFF POSITION NOTE*, 4 available at <https://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf> accessed 8th October 2017

[148] Albert J. Reiss, 'Selecting Strategies of Social Control over Organizational Life' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984)27-30; see also John Braithwaite, John Walker and Peter Grabosky, 'An Enforcement Taxonomy of Regulatory Agencies' (1987) 9.3 *LAW & POLICY*, 323, 344 where the authors, who were suspicious of the simple categorization of various enforcement styles into largely two types and conducted empiriacal study based on almost 100 regulatory agencies in Austrailia, also confirmed that "[t]he world, after all, is perhaps not all that much more complicated than suggested by those who would divide regulation into deterrence versus compliance…"

[149] Ibid

[150] Ibid

[151] John Braithwaite, *Restorative justice & responsive regulation* (Oxford University Press, 2002) 36-41; see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*Hart Publishing, 2015) location 15813 (kindle edition)

Enforcement and compliance are two sides of one coin. The regulatee selects a compliance strategy in response to the regulator's enforcement approach.[152] And the causes of compliance or non-compliance are closely connected to the regulatee's motivation for compliance.

Kagan et al. explained that the regulatees are motivated to comply with regulation by fear (legal license) or duty (normative license) and that compliance can be constrained by economic forces (economic license), which oblige the regulatees to meet the financial demands of shareholders or creditors.[153] In some situations, regulatory compliance may mean sacrificing profit and bonus and so can be to the disadvantage of the financial institution and its employees.[154] This means that compliance by the regulatee with potentially costly regulation requires the compulsory power of legal authority or normative duty.

Kagan and Scholz categorised the regulatee into three types based on motivation of compliance: amoral calculators, citizens, and incompetents.[155] An 'amoral calculator' is a regulatee who will breach regulation if the expected legal penalties don't extend beyond the profit earned from the breach.[156] They can be considered as ill-intended but well-informed regulatees who are incentivized to comply by legal license.[157] A 'citizen' is a regulatee who is inherently disposed to obey regulation unless it causes unreasonable cost or outcomes.[158] They can be considered as well-intended and well-informed, and

[152] Iain Macneil, 'Enforcement and Sanctioning' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015)

[153] Robert A. Kagan, Neil Gunningham, and Dorothy Thornton, 'Explaining corporate environmental performance: how does regulation matter?' [2003] 37.1 *Law & Society Review* 51; see also Robert A. Kagan, Neil Gunningham, and Dorothy Thornton, 'Fear, duty, and regulatory compliance: lessons from three research projects' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 37-49

[154] Richard Macrory, 'Reforming Regulatory Sanctions-Designing a Systemic Approach' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications (*Oxford University Press, 2010) 231

[155] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984)

[156] Ibid 69-70

[157] Robert Baldwin, *Rules and government* (n108)

[158] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n155) 75

motivated to comply mainly by normative license. An 'incompetent' is an ill-informed regulatee who doesn't understand the regulatory requirements.

As an example, a long and descriptive warning of investment risk written in fine letters printed on hundreds of pages can be an example of compliance by 'amoral calculators'. Strictly speaking, this defensive behavior of financial institutions can be said to comply with rules requiring explanation of all material risks, but the risk warned in that way cannot be expected to be recognized by the investors and so doesn't achieve the regulatory objective.[159]

Effectiveness of rule-enforcing

Deterrence-oriented enforcement tends to enhance the stability of a regulatory regime. Because this approach focuses on detecting breaches of rules and penalizing the wrongdoers, it should clarify whether behaviour is compliant or non-compliant and is penalized or non-penalized. This approach sees the regulatee's behaviour only as "black" or "white". This can damage rationality in some situations. For example, deterrence-oriented enforcement can penalize a well-intended *citizen*'s minor breach which doesn't threaten the regulatory objective, which results in uncooperative and antagonistic attitude toward regulation.

On the other hand, compliance-oriented enforcement enhances rationality. Under this approach, the line between compliance and non-compliance is blurry, and the goal of enforcement is to facilitate the regulatee to reach the regulatory objectives. Thus, the enforcer has the discretion to choose one of various enforcement options, from persuasion to adversarial sanctions, based on consideration about the circumstances and intentions of the regulatee. However, this can damage stability.

Each enforcement approach has advantages and disadvantages. Thus, the effectiveness of public enforcement is defined as balancing between compliance- and deterrence-oriented enforcement based on the regulated community's motivation to comply with regulation.

[159] See n956

1.3.2.3 Advantages and disadvantages of private enforcement and its effectiveness

Private enforcement through litigation is another important enforcement institution of COB for two main reasons. First, the COB is public law but deals with contractual relationships, which are the remit of private law.[160] So there is an overlap between COB and private law. A 'mis-selling' case can be brought simultaneously to the regulator and the court. Therefore, as private law and COB oversees the same behaviours, there can be legal uncertainty as well as counter-effectiveness if the relationship of the two enforcement institutions isn't designed well.[161] Second, public enforcement of COB has many limitations to achieve the intended regulatory outcome alone.[162]

This section examines the advantages and disadvantages of private enforcement and public enforcement. For a thorough comparison of the strengths and weaknesses of the two institutions, monitoring and intervention, the two sub-processes of enforcement, are examined below. [163]

Monitoring

Monitoring is the activity of detecting non-compliance with standards.[164] Inspection and audit by regulators comprise typical monitoring techniques.[165]

Monitoring isn't only limited to detecting misbehaviours from which a detriment has already occurred but could also include detection of misbehaviours that could potentially result in detriments. For instance, regulators sanction financial institutions for internal control failures where there is not detriment to consumers.[166] Pre-emptive monitoring is

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[160] See chapter V

[161] See section 5.3.1.

[162] Ibid

[163] Christopher Hood, *Tools of Government* (Maemillan, 1983) 3-4; see also Hugh Collins, *REGULATING CONTRACTS* (Oxford, 1999) 62; see also Fabrizio Cafaggi (n 1608) 205-235; for general analysis of strength and weakness of regulation and private law, see Anrei Shleifer 'The Enforcement Theory of Regulation' in Anrei Shleifer (ed), *The Failure of Judges and The Rise of Regulators* (MIT Press, 2012) 11-18

[164] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304, 315

[165] Ibid; monitoring can be conducted through alternative dispute resolution bodies, such as the UK's Financial Ombudsman Service.

[166] For example, see n968; see also Financial Supervisory Authority, FINAL NOTICE to SANTANDER UK PLC (2012)

a valuable role performed by regulators, since it can correct misbehaviours before detriments occur. In particular, the loss of public confidence in the financial services industry due to continuous occurrence of scandals renders proactive monitoring and actions critical.[167] Such a proactive approach is possible due to the independent ability of the regulator to monitor, investigate, and sanction without an action being raised by a victim.[168]

However, there is a risk of regulatory monitoring being focused on areas where the regulator is incentivised to monitor by its own internal or political agenda.[169] And selective monitoring could be exacerbated by the regulator's limited resources.[170] Hence, socially desirable monitoring cannot be conducted if the area that requires monitoring doesn't align with the regulator's agenda. The FSA acknowledged this when it confessed that a socially optimal level of regulatory monitoring and intervention was not conducted before the global crisis, because of its 'light touch' agenda.[171]

In private enforcement, monitoring isn't conducted by the agency (the court), but by those affected by the breach of law.[172] The court's remedy incentivizes them to monitor breaches and bring the breach to the court. This aspect provides private enforcement with an informational advantage in two ways. First, the person affected by the breach is better positioned than the regulator to detect contraventions because she is directly affected by the wrongdoing.[173] While it is impossible for the regulator to monitor and assess the legitimacy of numerous financial transactions, it can be said that private

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[167] See p179; see also Katharina Pistor and Chenggang Xu, 'Law enforcement under incomplete law: Theory and evidence from financial market regulation' (n145) 34

[168] Katharina Pistor and Chenggang Xu, 'Incomplete law' (n114) 935

[169] Matthew C Stephenson, 'Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' (2005) *Virginia Law Review* 93, 119

[170] Maria J. Glover, 'Structural Role of Private Enforcement Mechanism in Public Law' (2011) 53 *Wm. & Mary L. Rev.* 1137, 1148

[171] Financial Services Authority, 'A regulatory response to the global banking crisis' (Consultation Paper SP09/2, 2009) para 1.63-1.68; see also Alaistar Hudson, *The Law of Finance (*2nd edition, Sweet & Maxwell 2013) Para 7-63; see p176; see also Simson Gleeson, 'Culture, Supervision and Enforcement in Bank Regulation' in Patrick S. Kenadjian and Andreas Dombret*, Getting the culture and Ethics Right (*De Gruyter, 2016) location 1362

[172] ; Matthew C Stephenson, 'Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' (2005) *Virginia Law Review* 93, 108

[173] Ibid

enforcement has almost unlimited resources for monitoring.[174] Second, the absence of a central agency's involvement leaves no room for selective monitoring by the agency.[175]

However, the cost of litigation could present an obstacle for the harmed party that brings the breach to the court, thus hindering effective monitoring.[176] Further, monitoring in private enforcement is only retrospective, implying that contravention of the law can only be detected after the harm has been inflicted.[177]

As mentioned previously, there is complementarity in monitoring between the two institutions. The limitations of private enforcement's monitoring, namely its retrospective nature and burdensome costs, can be supplemented by the ex-ante and proactive monitoring of public enforcement. On the other hand, inadequate monitoring by the regulator due to selective monitoring and insufficient resources can be improved by the wider scope of individual monitoring in private enforcement.[178]

Intervention

Intervention encompasses not only a range of actions in the face of non-compliance with standards, but also supportive actions that assist the regulatee to comply.[179] The regulator has various coercive tools for enforcement: public censure, financial penalties, suspending permission, or cancelling of permission. Proactivity is the clearest advantage of public enforcement.[180] There is no reliance on requests for enforcement from those directly affected by a regulatory breach or from other third parties. Launching an investigation and initiating intervention is done at the regulator's discretion.[181] In

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[174] Allen M Linden, 'Tort Law as Ombudsman' (1973) 51 *Canadian Bar Review,* 155

[175] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304, 317

[176] Ibid 316; THIRUVALLORE T. ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State', in Kit Barker, Karen Fairweather and Ross Grantham, *Private Law in the 21st Century* (Bloomsbury, 2017) 13; see also Robert A. Kagan, *Adversarial legalism: The American way of law* (Harvard University Press, 2009) location 193; see also Stephen G. Breyer, *Regulation and its Reform* (Harvard University Press, 2009) location 2780

[177] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,316

[178] JAMES M. LANDIS, 'THE ADMINISTRATIVE PROCESS' (1938) 95; Allen M Linden, 'Tort Law as Ombudsman' (1973) 51 *Canadian Bar Review,* 155, 156 and 158-159

[179] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304 316

[180] Katharina Pistor and Chenggang Xu, 'Incomplete law' (n114) 954

[181] Joseph A. Grundfest, 'Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority' (1994) 107 *Harv. L. Rev.* 961, 970

deciding whether to enforce or intervene, the regulator will weigh the cost and benefit of the action.[182] This is enabled by the regulator's sufficient expertise to understand the impact of enforcement or non-enforcement on the market.[183]

The key disadvantage of public enforcement is the regulator's potential vulnerability to external influences,[184] which can originate from the political parties, other interest groups and even the entities being regulated.[185] The regulated entities can persuade the regulator consciously or unconsciously to under-enforce.[186] Politicians may put pressure on the regulator to achieve their preferable outcome on politically important issues.[187] As the regulator is answerable to parliament, it cannot be free from the pressures of political parties. The UK's IRHP scandal serves as an example, where the parliament's and an interest group's pressure influenced the regulator.[188]

In private enforcement, the court orders wrongdoers to compensate their victims; this functions as the tool of intervention.[189] The biggest advantage of private enforcement is the better insulation of the court's decision from the influence of political parties and interest groups.[190] This advantage is substantial since actions against standard violators tend to involve political risks; enforcers without the capability or willingness to bear the risks cannot take action.[191] Landes and Posner explained that the many tools available to put pressure on the judiciary—such as 'budget harassment', 'tinkering with the court's

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[182] Andrei Shleifer, 'Understanding regulation' (2005) 11.4 *European Financial Management* 439, 446

[183] Ibid

[184] Matthew C Stephenson, 'Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' (2005) *Virginia Law Review* 93, 110; see also Giandomenico Majone, 'Theories of Regulation' in Baake, Pio, et al. *Regulating europe* (Psychology Press, 1996) 41; see (Princeton University Press, 2015) 149

[185] Ibid

[186] George J. Stigler, 'The Theory of Economic Regulation', (1971) *The Bell journal of economics and management science* 3, 10-13

[187] Matthew C. Stephenson (n184) 119

[188] See p268

[189] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,317; Steven D. Shermer, 'Efficiency of Private Participation in Regulating and Enforcing the Federal Pollution Control Laws: A Model for Citizen Involvement' (1999) 14 *J. Envtl. L. & Litig.* 461, 477

[190] Richard A. Posner, *Economic Analysis of Law* (n614) 385 ; Andrei Shleifer, 'Understanding regulation' (2005) 11.4 *European Financial Management* 439, 444; Maria J. Glover (n 170) 1149

[191] Ana Carvajal, and Jennifer E. Elliott, 'The Challenge of Enforcement in Securities Markets: Mission Impossible?' (2009) 25 available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457591> accessed 13th March 2017

jurisdiction', and 'altering the composition of the judiciary'—cannot be used frequently since it could damage the perceived independence of the judiciary, resulting in costs to the beneficiaries of legislation.[192] In addition, the sharply contrasting interests between the plaintiff and the defendant[193] don't leave room for intrusion by a third party in the court's decision process.[194] The court's judgment in the South Korean KIKO disputes stated that there was no breach in the duty to protect customers in most of the cases despite the amiable opinion of the political community towards SMEs. This serves as a good example of the court's comparative advantage in being insulated from external influence.[195]

However, private enforcement has its disadvantages. First, access to private law is restricted. In addition to legal expenses,[196] the burden of proving that there was a violation of law, and a causal relationship between the violation and detriment, presents a further obstacle to the accessibility of private law.[197] This burden is illustrated in the fact that only one consumer could secure a compensation order out of eighteen cases of over-the-counter derivatives 'mis-selling' disputes in the UK.[198]

In the context of COB, the advantage as well as disadvantage of public enforcement is that the regulator is designed to speedily resolve large 'mis-selling' cases through standardisation.[199] As consumer characteristics and circumstances of each alleged 'mis-selling' case vary, an in-depth analysis of each transaction is required to accurately

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[192] William M. Landes and Richard A. Posner, 'The Independent Judiciary in an Interest-Group Perspective' (1975) 18 *J. Law & Econ.* 875, 885

[193] Ernest J. Weinrib, *The idea of private law* (OUP Oxford 2012) 76

[194] Andrew Robertson, 'Constraints on Policy-Based Reasoning in Private Law in Robertson' in Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009) 272

[195] See p 3 2

[196] See n1567; Hugh Collins, *REGULATING CONTRACTS* (Oxford, 1999) p87; Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,316

[197] Hugh Collins, *REGULATING CONTRACTS* (Oxford, 1999) 89; Federico Della Negra, 'The private enforcement of the MiFID conduct of business rules. An overview of the Italian and Spanish experiences' (2014) *European Review of Contract Law* 10.4, 571, 580

[198] See 5.1.1.6

[199] For example, see the process of regulatory redress for 'mis-selling' IRHPs at p268; see also Hans-W Micklitz, 'Administrative Enforcement of European Private Law' in Roger Brownsword et al**,** *The Foundations of Europeans Private Law (*Hart Publishing, 2011**)** 564 where he explained that mass production and mass consumption triggered mass damage, which needs collective enforcement.

determine whether there was 'mis-selling'. However, public enforcement isn't fit for conducting in-depth analysis of individual disputes. It is the court that is designed to consider the specific circumstances of each case in making its judgement.[200]

Effectiveness of private enforcement

The strengths and weaknesses of the two institutions demonstrate that one institution doesn't dominate and offer innate superiority over the other in the achievement of the two sub-processes, namely, monitoring and intervention. The disadvantages of each institution can be complemented by the other.[201] The regulator's vulnerability to external influence can be supplemented by the court's comparatively strong insulation from outside pressure.[202] A focus on individual cases, without considering the externality of its ruling, can be strength of private law for independent enforcement. On the other hand, the difficulty of accessing private enforcement could be supplemented by the proactive enforcement of regulation.

It means that, structurally, there could be a complementary interplay between private enforcement and public enforcement.[203] The two institutions are well positioned to achieve regulatory objectives, collaboratively.[204] Complementary interplay can achieve efficient 'division of labour' between the two institutions[205]

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[200] See section 5.3

[201] Fabrizio Cafaggi, *A coordinated approach to regulation and civil liability in European Law: Rethinking institutional complementarities* (European University Institute 2005) 196; Matthew C Stephenson, 'Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' (2005) *Virginia Law Review* 93, 107-112; Maria J. Glover (n170) 1161-1185

[202] J. Maria Glover (n 170) 1149; see also Deborah R. Hensler, 'Can private class actions enforce regulations? Do they? Should they?' in Francesca Bignami and David Zaring, *Comparative Law and Regulation (*Elgar, 2016) 268-269; Steven Shavell, 'Liability for harm versus regulation of safety' (No. w1218. National Bureau of Economic Research, 1983) 357

[203] Jonathan R. Hay and Andrei Shleifer, 'Private enforcement of public laws: A theory of legal reform' (1998) 88 *American Economic Review* 398, 400-401; Susan Rose-Ackerman, *Rethinking the progressive agenda* (Simon and Schuster 1993) ch8

[204] Simeon Djankov, et al. 'The new comparative economics' (2003) 6-17 <http://escholarship.org/uc/item/9rn8c3tq#page-18> ; Alaistar Hudson, 'The synthesis of public and private in finance law' in Barker, Kit, and Darryn Jensen (eds), *Private law: key encounters with public law* (Cambridge University Press 2013); Steven Shavell, *Liability for harm versus regulation of safety* (No. w1218. National Bureau of Economic Research, 1983) 357

[205] Steven D. Shermer (n 189) 469

However, how the relationship between private law and COB is designed decides whether the two enforcement institutions have complementary or counter-effective interplay. Thus, the effectiveness of private enforcement can be defined as the extent that public and private enforcement have a complementary relationship.

1.3.2.4 Regulatory strategies

Different regulatory strategies can be developed based on varied combinations of the different approaches in rule-making and rule-enforcing discussed in the forgoing sections. For example, the government may regulate 'mis-selling' directly by means of a statutory agency with the approach of precise rule-making and deterrence-focused enforcement; or it may rely on the firms' self-regulation with the approach of vague rule-making and compliance-focused enforcement.

The simple and basic strategy of regulation is "command and control" where the regulator orders what to do and penalizes the non-compliers and the regulatee just follows the order. However, practically and theoretically, this simple strategy has been proved to be ineffective in achieving the regulatory purpose.[206] Thus, over the last 30 years, both practitioners and theorists have scrutinized the strategies of regulation, particularly in the financial industry. These strategies are not exclusive of each other but may be related and can be used together, but they have different advantages and disadvantages and so they raise different practical issues.[207] This section explores the various regulatory strategies which have been designed and applied.

Command and Control

The core concept of 'command and control' ("CAC") is that the state regulates through use of statutory rules backed by legal sanctions.[208] Under this strategy, the state tries to control directly what the regulatee does, rather than present the desired outcomes. CAC

[206] For example, Robert Baldwin, 'Regulation after 'command and control' in Keith Hawkins, *The Human Face of Law (*Oxford University Press, 1997)

[207] Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 222

[208] Julia Black, 'Critical reflections on regulation' (2002) 2 Available at http://eprints.lse.ac.uk/35985/ accessed 15th June 2017

regulation has several features; firstly, it mainly uses the imposition of sanctions on non-compliers;[209] secondly, the task of enforcement is carried out by a public agency usually with the power of detailed rule-making; [210] thirdly, the rule-making approach is predominantly process- or activity- based with precise rule-types.[211] Thus, it is centered regulation in that it assumes that the state determines what to do, and the regulatee follows. [212] It is based on simple cause-effect relations and it envisages "a linear progression from policy formation through to implementation".[213]

The strength of CAC regulation is its clarity and immediacy in making and enforcing standards. By classifying types of behavior as acceptable or not, [214] some forms of behavior can be prohibited completely. As a result, CAC regulation can politically ensure the public that they are aided by the law.[215]

However, CAC regulation has been accused of many weaknesses by a number of scholars. [216] The first weakness is the information and knowledge failure by the government.[217] The regulatory process, from identifying non-compliances, finding causes of problems to crafting solutions requires information and knowledge about the business practice but the government lacks them.[218] The second weakness of CAC regulation is the rigid legalism. It tends to make inflexible and rigid rules, partly because of the rule-maker's lack of information, and these rules have high propensity to lead to legalistic

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[209] Julia Black, 'Enrolling actors in regulatory systems: examples from UK financial services Regulation' [2003] *Public Law* 63

[210] Ibid

[211] Anthony Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' (2004) *Leading Issues in Competition, Regulation and Development*,146, 167

[212] Julia Black, 'Critical reflections on regulation' (2002) 2 available at http://eprints.lse.ac.uk/35985/ accessed 15th June 2017

[213] Ibid

[214] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation* (Oxford University Press 2011) 106-107

[215] Ibid

[216] For example, see Stephen G. Breyer, *Regulation and its Reform* (n176); see also Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (Transaction Publishers, 1982)

[217] Julia Black, 'Critical reflections on regulation' (2002) 2 Available at http://eprints.lse.ac.uk/35985/ accessed 15th June 2017

[218] Ibid 3

enforcement.[219] Lastly but more importantly, CAC regulation may lead the regulatee to only focus on letters of rules while ignoring its purpose.[220] This means that CAC regulation can fail in achieving its goal even when the regulatee's compliance is obtained.

Risk-based regulation

Risk-based regulation[221] is a response to the practical challenge that regulators have for exercising control over a large group of regulatees.[222] Through risk-based regulation, regulators focus on areas which pose high risks to the regulatory objectives, and anticipate problems rather than just react to them.[223] For this, the FSA developed its risk-assessment framework, which was customized to fit the risks that the regulated firms posed to the regulatory objectives;[224] the regulated firms were categorized on the basis of both the probability of particular risks and the impact of those risks should they occur.[225] Then more regulatory resources would be allocated to firms with high-impact risks.[226]

Black explained the difference between risk-based regulation and regulators' routine decision-making which inherently requires prioritization, by stating that risk-based regulation moves those decisions "in and up organization from inspectors to boards".[227] In other words, risk-based regulation enables clear, transparent and systematic prioritization which is inevitable in regulatory process.[228]

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[219] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation* (Oxford University Press 2011) 108

[220] Charles L. Schultze, 'Public Use of Private Interest' (1977) 254.1524 *Harpers* 43, 56

[221] The risk-based regulation is a regulatory strategy the FSA announced in 2000, which later has been adopted by many OECD jurisdictions. See Bridget Hutter, 'The attractions of risk-based regulation: accounting for the emergence of risk ideas in regulation' [2005] 33 *Centre for Analysis of Risk and Regulation Discussion Paper,* available at https://web.actuaries.ie/sites/default/files/erm-resources/205_The_attractions_of_risk_based_regulation_accounting_for_the_emergence_of_risk_ideas_in_regulation.pdf accessed 10th Oct 2018

[222] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (Hart Publishing, 2015) location 8972

[223] Financial Sueprvisory Agency, A New Regulator for the New Millennium (2000)

[224] Ibid

[225] Ibid

[226] Ibid

[227] Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 222

[228] Ibid

However, the systematization of prioritizing in risk-based regulation entails weaknesses. Regulators face different kinds of risks and official prioritization among the risks exposes them to vulnerability;[229] risks can materialize at any time, and so risk-based regulation can be attacked easily in hindsight. So Black argued that regulators need political support to adopt risk-based regulation, let alone their formal legal powers.[230]

Meta-regulation

Meta-regulation is a strategy which delegates the risk control function to the regulated firms instead of carrying out regulation centrally.[231] Osborn expressed this approach as "steering rather than rowing".[232] So the main responsibility of achieving regulatory goals is placed on the firms' internal management systems, and the primary role of the regulator is auditing the performance of the firms' systems.[233] Under this strategy, the regulator demands firms to demonstrate that their internal control system can secure compliance with regulation.[234]

Thus, meta-regulation is a form of decentred regulation which is based on the idea that governments don't have a monopoly on regulation and regulation can be operated by other social actors.[235] Meta-regulation has the advantage that it enables firms to design their systems and processes which are better suited to ensuring that regulatory goals are achieved than generic and prescriptive rules.[236] In terms of enforcement, it places the responsibilities on firms themselves to demonstrate compliance, rather than requiring regulators to detect non-compliance.[237] This enforcement approach is much more cost-

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[229] Ibid
[230] Ibid
[231] Christine Parker, *The open corporation: Effective self-regulation and democracy* (Cambridge University Press, 2002); John Braithwaite, 'Meta risk management and responsive regulation for tax system integrity' 25.1 [2003] *Law & Policy*, 1
[232] David Osborne, 'Reinventing government' [1993] *Public productivity & management Review,* 349
[233] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding regulation* (Oxford University Press 2011) 147
[234] Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 220-223
[235] Cary Coglianese and Jennifer Nash (eds), *Regulating from the inside: can environmental management systems achieve policy goals?* (Resources for the Future, 2001) chapter 1
[236] Ibid
[237] Robert Baldwin, *Rules and government* (n108)*17-18;* Justin O'Brien, *Redesigning Financial Regulation (*Wiely, 2006) 162

efficient because detecting non-compliance requires a lot of time and resources compared with the firms' proving their ability of compliance.

Meta-regulation isn't free from weaknesses. It cannot deal with the situation where the goal of the firms' management system doesn't align with the regulatory goal.[238] Thus, for the success of meta-regulation, there should be right incentives for the firms to pursue the regulatory goals along with their private goals.

Principle-based regulation

Principle-based regulation ("PBR") defines the outcomes to achieve rather than the detailed processes or activities the regulatee should follow.[239] Therefore PBR can be renamed as outcome-focused regulation.[240] It is based on the belief that the regulatees themselves are better positioned to know the most effective way to reach the regulatory goal. It allows and requires the regulated firms to determine the processes and actions to achieve the regulatory objectives.[241] PBR sees the regulated firms as proactive partners in achieving the objectives rather than passive subjects to be regulated. Therefore, PBR should rely on the regulated firms' capability and sound will of self-regulation. PBR would make a good combination with meta-regulation.[242]

The first advantage of PBR is that compliance can secure achieving regulatory objectives because the requirements themselves define the regulatory objectives.[243] Due to the limit of language and nature of rules, rules cannot avoid gaps, omissions or over-inclusion,

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[238] Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 225-227

[239] Julia Black, 'The rise, fall and fate of principles based regulation' (2010) available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712862> accessed 13th February 2017

[240] Femke de Vries, 'How Can Principle-Based Regulation Contribute to Good Supervision?' in A. Joanne Kellerman, Jacob De Haan and Femke De Vries, *Financial Supervision in the 21st Century* (Springer Berlin Heidelberg, 2013) 162-165

[241] Cary Coglianese, Jennifer Nash, and Todd Olmstead, 'Performance-based regulation: Prospects and limitations in health, safety, and environmental protection' [2003] 55 *Admin. L. Rev.* 705

[242] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (2008) LSE Law, Society and Economy Working Papers 13/2008, 35-36 available <www.lse.ac.uk/collections/law/wps/wps.htm> accessed 6th April 2017

[243] Ibid

and thus compliance with detailed rules cannot guarantee the achievement of regulatory objectives.[244]

Further, PBR can prevent 'creative compliance'[245] which refers to the practice of using the law to escape legal control without actually violating legal rules.[246]

However, PBR has weaknesses too. One of the weaknesses is that it is harder and more costly to comply with and enforce than detailed rule-based regulation.[247] Compliance with broad regulatory objectives requires the regulated firms to accept the responsibility to achieve the objectives and set out their own compliance strategies and processes. This proactive compliance needs more resources than a tick-box approach.[248] In terms of enforcement, PBR requires enforcers to verify that the regulatory purpose is complied with[249] and this in-depth investigation demands more resources. In addition, PBR needs skillful and experienced enforcers who can utilize properly the discretion and flexibility given by PBR.[250]

1.3.2.5 Explanation of different regulatory strategies

After identifying the different regulatory approaches and strategies which South Korea and the UK take in terms of COB, explaining the causes of differences and similarities is the next step in this comparative research, as discussed in section 1.3.1. This section takes a look at theories explaining the factors affecting each jurisdiction in choosing a regulatory strategy. It is inevitable, Foster argued, that there are regulatory offences in a society, and that how the offences are expressed, monitored and controlled can be only chosen "in the context of the constitution, laws and political habits" in each

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[244] Ibid
[245] Doreen McBarnet and Christopher Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' [1991] 54 *Mordern Law Review*
[246] Julia Black, 'Using rules effectively' in Christopher McCrudden, *Regulation and Deregulation (*Clarendon Press, 1999) 105-107
[247] Julia Black, 'The rise, fall and fate of principles based regulation' (2010) available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712862> accessed 13th February 2017
[248] Ibid
[249] Ibid
[250] Ibid

jurisdiction.[251] Below, the section will examine how constitution, legal tradition, politics influence the shaping of regulatory strategies in jurisdictions.

Constitution and legal tradition

As regulation is the legal institution refraining certain behaviours of citizens, it must involve the exercise of the state's power.[252] Constitutions control the state's power, by allocating it between legislature, executive and judiciary and by defining how the state can exercise its power.[253] Under modern democratic constitutions, the power to regulate people only comes from legislature which represents the people, but the constitution of each jurisdiction has its own way to fulfil it.[254]

As regulatory issues in a society become fragmented and specialized, primary legislations delegates defining more detailed requirements to the executive.[255] However, the delegation has different shapes in each jurisdiction. For example, South Korea's constitution has the 'principle of pre-formulation of state actions by legislation' which demands all substantive legal restriction be promulgated only in the primary legislation. On the contrary, French constitution grants directly to the executive the power to regulate in some sectors.[256] Daintith said that democratic ideals can be sacrificed for other values through a political and ideological choice.[257]

As exemplified above, the way of legislating, which decides the extent of the discretion the executive has in regulating, varies significantly among jurisdictions. Ogus explained that common law jurisdictions can use vague vocabulary in legislation and so allow a

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[251] Christopher D Foster, *Privatization, public ownership, and the regulation of natural monopoly* (Wiley-Blackwell, 1992) 416-418

[252] Anthony Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' (2004) *Leading Issues in Competition, Regulation and Development*,146, 149

[253] Andr s Saj, *Limiting government: an introduction to constitutionalism* (Central European University Press, 1999)

[254] Ibid

[255] Robert Baldwin, *Rules and government* (n108)*17-18;* Justin O'Brien, *Redesigning Financial Regulation (*Wiely, 2006)

[256] Anthony Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' (2004) *Leading Issues in Competition, Regulation and Development*,146, 149

[257] Dainith Terence, 'Regulation' in Rene David, *International Encyclopedia of Comparative Law* (Mohr,1997) 77-81

broad range of discretion for the regulator while civil law jurisdictions tend to use clearer and more specific language.[258]

The power granted to the judiciary is also varied among jurisdictions. In some countries like Germany and South Korea, the court has the power to annul legislation which doesn't abide by the constitution while this isn't the case in other countries like the UK.[259]

These differences originating from constitution and legal origin can affect substantially the approach of rule-making in primary and secondary legislation.

Political culture – relationship between the government and businesses

Vogel argued that, based on his comparative study of regulatory styles between the UK and the US, regulation of the corporate's social conduct is rooted in the tradition of interaction among government, business and the public.[260] He said that there should be examination of not only the constitutional system but also political culture in order to understand the tradition of interaction among those constituents of a society.

A defining characteristic of a political culture can be the extent of the power of the state on its own society.[261] Krasner explained that "weak states" are countries which cannot execute their own policy goals without the support of other groups in the society while "strong states" are countries which can do this by themselves. Gerschenkron categorized weak and strong states based on the timing of industrialization.[262] He explained that early industrialized countries had the opportunity to develop more advanced and deeper capital markets with relatively autonomous firms, whereas later industrialized ones had firms more dependent on the state as a source of capital.[263] Thus, he concluded that the

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[258] Anthony Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' (2004) *Leading Issues in Competition, Regulation and Development,* 146, 160

[259] Ibid 151

[260] David Vogel, *National Styles of Regulation (*Cornel University Press, 1986) 264

[261] Stephen D. Krasner, 'US commercial and monetary policy: unravelling the paradox of external strength and internal weakness' (1977) 31.4 *International Organization*, 635, 641

[262] Alexander Gerschenkron, *Economic backwardness in historical perspective: a book of essays* (Cambridge, MA: Belknap Press of Harvard University Press, 1962)

[263] Ibid

countries which industrialized later tended to have governments with larger and more important roles in allocating capital and tended to be "strong states".[264]

Vogel contended that the UK was an early industrializer and so was a "weak state" which lacked direct control of the industry.[265] Thus, according to him, the consultative/negotiative practice in the regulatory process of the UK comes from a broad cultural norm that regulation should regulate by consent.[266] These norms influenced molding the relationship between regulators and industries, and rendered policy-makers to work closely with the industries.[267] They rely heavily on industries' expertise and advice, generally secure their consent before formulating changes in policies, and whenever possible rely on them to implement regulations that are then adopted.[268]

He contrasted with the situations of "strong states" like France and Japan. The governments here had a variety of regulatory leverages by which they could show the direction of industrial activity and refrain industry from accessing the political process.[269] South Korea has many characteristics of "strong states", as a country that experienced very fast and state-led late industrialization in the 1970s.

The thesis will use the above theories of constitution, legal tradition and political culture to explain the different regulatory strategies between South Korea and the UK.

1.3.2.6 Evaluation of effectiveness

The last step of this research is to evaluate the COB regimes. The evaluation criteria or the "point of view" of the comparison in this thesis is the effectiveness of regulation, which is defined in previous sections. This section describes the method of how to evaluate effectiveness of the COB regimes of South Korea and the UK.

The problem of cost-benefit analysis

[264] Ibid
[265] David Vogel, *National Styles of Regulation (*Cornel University Press, 1986) 264-269
[266] Ibid 287
[267] Ibid
[268] Ibid 264-287
[269] Ibid

In theory, the best method of evaluating effectiveness is to measure the social costs and benefits of regulation. However, it is impossible to accurately do this, especially with a financial regulation like COB for the reasons stated below.[270]

First, in terms of costs, costs from the adoption of a regulation consist of administrative costs that come from making and enforcing it, compliance costs, and indirect costs from its external effects.[271] Although unreliable, administrative costs and compliance costs can be roughly calculated by estimating the additional human resources and material costs which will be incurred for complying with the new rule.[272] However, the indirect cost is intractable.[273] For example, if the transaction of a particular financial product is prohibited, the possible gain which could have been exploited by consumers through the transaction of that product would be indirect costs. This indirect cost represents the amount of socially beneficial transactions deterred because of the new regulation. Because this intervention would involve so many circumstances and constituents, an estimate cannot be made.[274] A method which can identify the preferences of each constituent of society and then add them to obtain a measure for the society as a whole would be needed. However, such a method is impossible to develop.[275]

Generally speaking, estimating the benefit of a newly adopted regulation is more difficult.[276] First, when measuring benefits, measuring the incremental benefit from the

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[270] See, for example, L.C.B. Gower, 'Review of Investor Protection: Report' (HM Stationery Office, Cmd., No. 9215, 1984) para 1.16; see also Wim Boonstra and Allard Bruinshoofd, 'The Costs of State Intervention in the Financial Sector' in Alberto Alemmano et al*, Better Business Regulation in A Risk Society (*Springer, 2012) location 333 and 2801-2995 (kindle edition); see also Julie Froud et al, *Controlling The Regulators (*Macmillan Press, 1998) 10

[271] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing 2004) Ch8

[272] Howell E. Jackson, 'Variation in the intensity of financial regulation: Preliminary evidence and potential implications' (2007) 24 *Yale J. on Reg*, 253, 260-261

[273] Ibid; Charles Albert Eric Goodhart, *Financial Regulation: Why, how, and where now?* (Psychology Press, 1998) 65

[274] For example, see Arthur B. Laby, 'Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries' (2012) 87 *Wash. L. Rev.* 707, 749, where the author estimated the suitability requirement would cause twelve to seventeen million retail investors in the US to lose access to advisory services.

[275] Dan Awrey, 'Complexity, Innovation, and the Regulation of Modern Financial Markets' (2012) 2:2 *Harvard Business Law Review* 235, 276

[276] Charles Albert Eric Goodhart, *Financial Regulation: Why, how, and where now?* (n273) 61-65; Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) Ch8; see also see also Julie Froud, et al., *Controlling the Regulators* (Springer, 1998) 1

additional regulation is difficult because defining the causal relationship between the regulation and the benefit isn't easy.[277] Second, the benefit from a regulation tends to be 'diffused in character and significantly removed in time and space', which makes measurement very difficult.[278]

Although the financial regulator in the UK is required to undertake a cost–benefit analysis before introducing a regulation,[279] the regulator has admitted that precise calculation of the cost and benefit is impossible.[280] The cost–benefit analysis required by statute can have meaning to the extent that it can provide an opportunity for the rule-maker to consider the probable costs and benefits of a new regulation.[281]

Empirical observation

Örücü argued that the selection of 'better law' isn't an easy task because by making choices "*drafters take up positions and express value judgements*".[282] Thus he argued the evaluation should rely on "data".[283] To overcome the subjectivity of evaluation, the thesis "begin[s] with facts rather than hypotheses" in evaluating effectiveness.[284] In other

[277] For example, if a regulation is introduced which requires a financial institution to check the suitability of a financial instrument for a consumer, it is difficult to define the individual causal relationship which will show by how much the possible damage from 'mis-selling' will be reduced because of the introduction of this regulation in addition to other existing regulations; see Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) Ch8

[278] Ibid

[279] FSMA 2000, s138I

[280] Clive Briault, 'The Costs of Regulation' (2003) speech by a director of Financial Services Authority, available at < http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp140.노스|> accessed 21 November 2016; Charles Albert Eric Goodhart, 'Regulating the Regulator-An Economist's Perspective on accountability and Control' in Charles Albert Eric Goodhart, *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing, 2001) 151, 153, where the author pointed out that to determine whether regulations are achieving their aims is a process which is 'non-operational in the sense that no measurement of success can be achieved'.

[281] John C. Coates IV, 'Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications' (2014) 124 *Yale LJ* 882, 891-899

[282] Esin Örücü, *The enigma of comparative law: variations on a theme for the twenty-first century* (Springer, 2013) 43-44

[283] Ibid

[284] Esin Örücü, 'Developing Comparative Law' in Esin Örücü and David Nelken (eds), *Comparative law: A handbook* (Bloomsbury Publishing, 2007) 48

words, this research uses empirical observation to examine how the different approaches to rule-making and rule-enforcing have causality to regulatory outcomes.[285]

First, the effectiveness of rule-making is evaluated by analyzing the causal relationship between different rule-making approaches and their regulatory outcomes such as attitudes both of the regulator and the regulatee and the extent that compliance of rules fulfils the regulatory objectives.

Second, the effectiveness of rule-enforcing is evaluated through enforcement cases. May and Burby argued that "[t]he observed practices can be used to deduce an underlying enforcement philosophy."[286] An enforcement approach may not necessarily be made public; moreover, even if it is made public, the reality may differ. Consequently, in order to conduct research on enforcement, an inductive approach is appropriate.[287] Enforcement cases provide information on the regulator's enforcement strategy and what is breached by the regulatee. The information about breaches shows the impact of the regulation on the behaviour of the regulatee. If the COB successfully induces the intended behaviour from the regulatee, then the enforcement can be said to be effective.

Third, the effectiveness of private enforcement can also be evaluated by analysing the adjudicated cases in court. This thesis identifies the standard and approach which the court adopts in its adjudications of 'mis-selling' disputes. This analysis will reveal how much private enforcement in the two countries harmonizes with public enforcement.

In the thesis, the analysis of regulation is divided into rule-making and rule-enforcing. Rules are 'abstract and universalistic', but the enforcement of rules is 'concrete and

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[285] Esin Örücü, 'A Project: Comparative Law in Action' in Esin Örücü and David Nelken (eds), *Comparative law: A handbook* (Bloomsbury Publishing, 2007) 438; Gerhard Danneman, 'Comparative law: Study of similarities or differences?' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford handbook of comparative law* (OUP Oxford, 2006) 403; see also Esin Örücü, *The enigma of comparative law: variations on a theme for the twenty-first century* (Springer, 2013) 43-44; Geoffrey Samuel, *An Introduction of Comparative Theory (*Hart Publishing, 2014) location 1386 (kindle version) where the author argued that the "*lack of empirical research can undermine the assertion of comparatists*."

[286] Peter May and Raymond Burby, 'Making sense out of regulatory enforcement' (1998) 20.2 *Law & Policy,* 157, 161

[287] Roscoe Pound, 'The scope and purpose of sociological jurisprudence' (1911) 25.2 *Harvard Law Review* 140, 166

particularistic'.[288] However, it should be remembered that the line dividing regulation in the book and regulation in action isn't clear-cut, and they are closely connected. [289] For example, the 'Guidance' [290] of the UK's COBS is one element of the rulebook; the Guidance can therefore be considered as one activity of rule-making. However, when considered a tool to support compliance with the 'Rule' which has a binding effect, the Guidance can also be seen as regulation in action. Another example is that design of under- or over-inclusive rules could be seen as a concern of rule-making. However, if such problematic rules result from a lack of competence of enforcers at implementation level, it would be an enforcement issue. In contrast, a competent enforcer could effectively enforce an incomplete rule in line with the purpose of the regulation.[291] Therefore, this thesis suggests reform in a comprehensive way even though the comparative analysis is conducted in rule-making and rule-enforcing separately.

1.4 Literature review

The existing literature in both the UK and South Korea in two main fields of inquiry has been surveyed and examined during the conduct of this research. Namely, Comparative law and Regulation, and the insights these writers offer have been used where relevant to inform the analysis and development of research questions. The contributions of the main writers whose work is used herein are summarized below and are referred to and used throughout the subsequent chapters.

1.4.1 Literature on comparative law

Literature on general comparative law

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[288] Salo Coslovsky et al., 'The Pragmatic Politics of Regulatory Enforcement' in David Levi-Faur, *Handbook on the Politics of Regulation (*Edward Elgar Publishing, 2013) 322

[289] Julia Black, '"Which Arrow?": Rule Type and Regulatory Policy' (1995) *Public Law* 94, 99; see also Niamh Moloney, 'The European Securities and Markets Authority and institutional design for the EU financial market – a tale of two competences: Part (2) rules in action' (2011) 12.02 *European business organization law review*, 177, 179; see also Keith Hawkins and John M. Thomas, 'Rule Making and Discretion: Implications for Designing Regulatory Policy' in Keith Hawkins and John M. Thomas, *Making Regulatory Policy (*University of Pittsburgh Press, 1989) 265; see also Robert Baldwin, 'Why rules don't work' [1990] 53.3 *The Modern Law Review* 321, 336-337

[290] See p 8 9

[291] Robert Baldwin, 'Why rules don't work' (n289) 336-337

Zeigert and Kotz provided answers on fundamental questions about comparative law: its purposes, subjects and methodologies. They argued that a key objective of comparative law is to provide solution options to enable the scholar with "critical capacity" to identify the "better solution" and that therefore, the methodology of comparative law should be based on the principle of functionality, stating that "[i]ncomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfill the same function." However, their argument is limited in that they couldn't specify the criteria for identifying the better solution.[292]

Hill considered the function of comparative law in the field of law reform.[293] He criticized Zweigert and Kotz's argument that an evaluation of the various solutions provided by different legal systems is to be made by considering "which is best adapted to its purpose and operates most justly" by disputing that the two criteria of purpose and justice involve value-judgments. He explained that criterion such as justice is "notoriously indeterminate" and attempts to identify the purpose of legal institutions also depends on subjective interpretations, which cannot be divorced from value-judgments. Instead, he concluded that comparative studies both tend to foster "a greater degree of detachment, a greater scepticism about taking the assumptions and values underlying the English legal system for granted" and offer "a greater variety of solutions than could be thought up."[294]

Sacco focused on objects of comparison in comparative law.[295] He argued that "it was a wrong belief that the legal rule in force was only one such rule, but that a researcher should recognize that "living law contains many different elements such as the formulations of scholars, and the decisions of judges-elements", which he called "legal formants." He added about legal formants that "[i]n order to see the entire law, it is

[292] Konrad Zweigert and Hein Kotz, *An Introduction To Comparative Law* (Oxford University Press, 1998) 46 where they cited Rabel's comment of "[l]awyers who are used to criticism and are animated by the desire to improve the law and hardly prevent themselves from seeing and commenting upon the better practical rule."
[293] Jonathan Hill, 'Comparative Law, Law Reform and Legal Theory' [1989] 9 Oxford J. Legal Stud. 101
[294] Ibid 105-106
[295] Rodolfo Sacco, 'Legal formants: A Dynamic Approach to Comparative Law' [1991] 39.1 *The American Journal of Comparative Law,* 1

necessary to find a suitable place for statute, definition, reason and so forth. If his concept of legal formants is applied to COB, law would encompass rules of the first and secondary legislation, enforcement strategy of regulators and adjudications of the court.

Pizzola explored the reasons behind the absence of comparative studies on financial regulation.[296] He explained that the reasons were related with traditional rigid comparative law compartmentalization - the private/public law distinction and legal families. The first reason was the cross-sectoral nature of financial regulation. According to him, comparative law is one of the few fields in which "the same research area is clearly split between a private and public compartment". He pointed out, financial regulation had the distinctive features of two legal concepts merging to form a single legal entity. His second reason was because financial regulation was a merger of features which belong to different legal families. He explained that financial regulation had always been detached from the traditional dichotomy of civil law and common law families. Nevertheless, according to him, most comparative scholars' works still reflect the basic assumptions that legal family was indeed crucial to comparative study. Against this background, he urged that comparative law needed a flexible methodology. More specifically, he argued that comparative lawyers engaging in financial regulation analysis should ask themselves: "(i) *why* a comparative scrutiny is beneficial for the study of the selected issue; (ii) *how* to integrate trans-disciplinary conversations; and (iii) *what* aspects of the researched topic better serve the cause of comparison."

Literature on law and finance

La Porta et al. adopted comparative methodology to find the effects of legal rules on financial development.[297] They measured the effectiveness of legal rules governing investor protection in 49 countries. This measurement showed that the level of protection for investors varied among these countries. Then they empirically revealed that the strength of legal rules for protecting investors had a strong correlation with

[296] Agnes Pizzolla, 'Comparative Law and Financial Regulation' [2011] 3.2 Irish Journal of Legal Studies 118

[297] La Porta R, Lopez-de-Silanes, Andrei Shleifer and Vinshy R, 'Legal determinants of external finance'[1997] 3 *Journal of Finance* 1131; La Porta R, Lopez-de-Silanes, Shleifer A and Vinshy R, 'Law and finance' [1998] 106 *Journal of Political Economy* 1113

legal origins; common law countries had more protective legal rules for outside investors than civil law countries. They also tested the correlation between the level of protection for investors and financial development of a given country and found that legal investor protection had strong positive correlation with financial development.

Beck et al. supported La Porta et al.'s conclusion by suggesting the mechanisms through which legal origins could affect financial development.[298] The first channel found was the "political channel" which referred to the difference where common law countries gave priority to private property rights while rights of the state were prioritized in civil law countries. Thus, it was argued that the state retained more influential power in civil law countries. The second channel was the "adaptability channel" which meant that different legal origins had different adaptability in changing socio-economic circumstances. They argued that common law countries are more flexible based on the case law system while civil law countries inherently have a more rigid legal system. They concluded that civil law countries had a top-down policy-implementation whereas common law countries tended to have a market-supporting focus.

Siems challenged law and finance literatures' argument that legal origin has explanatory power on financial development.[299] He pointed out that categorization of countries into legal families is arbitrary. For example, although Japan copied many parts of German legal codes in the 19th century, and so was classified as having a German legal origin by law and finance scholars, its Commercial Code was influenced substantially by the US after the 1940s. He argued that legal culture is more meaningful for understanding different legal systems. Legal couture covers, according to him, "historical background", "sources of law", "the style of codification", and "the ranking of law in social order". Thus, he suggested more precise criteria to classify different countries' legal systems: "the proxies of colonization", "language", "importance of statutory and case law", and "formality and flexibility of legal systems".

[298] Thorsten Beck et al., 'Law and Finance. Why Does Legal Origin Matter?' [2003] 31 *J. Comp. Econ.* 653
[299] Mathias Siems, 'Legal Origins: Reconciling Law & Finance and Comparative Law' (2007) 52 *McGill Law Journal* 55

Pistor et al. raised the question on La Porta et al.'s approach of focusing on formal legal rules in finding correlation with financial development; they empirically revealed that high level of legal protection by statutory rules for external finance didn't guarantee similar level of enforcement.[300] They found that the effectiveness of enforcement had a much stronger impact on external finance than law on the books.

Armour et al.'s empirical study supported the Pistor et al.'s conclusion.[301] They found that civil law countries had caught up with the common law countries with respect to the formal level of investor protection during the mid-1990s to mid-2010s. However, they couldn't find any evidence of the impact of the legal change on the stock market volume in those civil countries. They interpreted that there could be two possibilities for this result: first, legal rules for investor protection had already been sufficient and the additional legal changes couldn't have any effect; secondly, reformed legal rules didn't work well as expected in civil law countries.

1.4.2 Literature on regulation

Literature on rule-making

Hart answered the question of *"what are rules and how do they function in a legal system?"*[302] According to him, the nature and role of rule is summarized in this sentence: "[o]ur justification for assigning to the union of primary and secondary rules this central place isn't that they will there do the work of a dictionary, but that they have great explanatory power." He argued that the formulation of rules cannot avoid the inherent limit of uncertainty due to the nature of language and that rules are "open texture". He also argued that all legal systems require a compromise between the "need of certain rules" and the "need for later settlement by an informed official choice".

[300] Katharina Pistor, Martin Raiser, and Stanislaw Gelfer, 'Law and finance in transition economies' [2000] 8.2 *Economics of transition*, 325

[301] John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siemss, and Ajit Singh, 'Shareholder protection and stock market development: an empirical test of the legal origins hypothesis' [2009] 6.2 *Journal of Empirical Legal Studies*, 343

[302] Herbert Lionel Adolphus Hart et al., *The concept of law*. Oxford University Press (2012)

Shauer discussed the meaning, structure and nature of rules and defined rules as generalization.[303] He described generalization as the process of requiring selection and suppression. The generalization of particular actions involves certain common characteristics being selected and the rest being suppressed. And rules connect those common characteristics and the probabilistic occurrence of particular events. So his argument was that rules cannot but be potentially under- or over- inclusive because of the unavoidable gap between the universality of the statement of rules and the probabilistic nature of consequences. He distinguished two different generalization models which are the "conversational model" and the "entrench model". Under the conversational model, rules are adaptable to specific circumstances, while under the entrench model, rules are absolute decision-references. He argued that the attempt to decrease the errors under the conversational model would increase the likelihood of errors of under- and over- inclusiveness. Thus, he added that there cannot be any absolute better model and there is a tradeoff between the two types of errors.

Hart and Shauer shared the argument that rules are not a perfect device as a reference for decision-making and that a harmonious balance with discretion is needed. Their analysis and argument about rules' function and limitation is reflected in the framework of this thesis.[304]

Diver looked at the practical problem of how precisely rules should be made.[305] He was concerned about how to minimize the social costs incurred from imprecision of rules. He distinguished three values related with rule precision - transparency, accessibility, and congruency, and argued that a rule should have these three values for realizing its purpose. He showed that these three values had a trade-off relationship and developed a framework to determine the appropriate level of rule-precision, which identified four principal categories of cost-sources depending on the level of rule precision: "rate of compliance", "over- and under- inclusiveness", "cost of rule-making", and "cost of applying

[303] Frederick Schauer, *Playing by the Rules: A Philosophical Examination of Rule-based Decision-making in Law and in Life* (Clarendon Press, 1991)
[304] See section 1.5.1
[305] Colin S. Diver, 'The optimal precision of administrative rules' (n140)

a rule". He suggested that rule-makers should select the rulemaking method with minimum social cost by assessing the four principal sources of cost. However, he acknowledged that generalization of the perfect level of rule-precision isn't possible, and thus the appropriate degree of rule precision is dependent on the related circumstances. His analysis that there is a trade-off relationship between the values that rules should pursue provides important insight for defining the effectiveness of regulation in this thesis.[306]

Posner's research was also on the precision of rules.[307] He began with a choice on a continuum between precision and generality in formulating legal rules with the objective of maximizing the efficiency of the legal process. He analyzed over- and under-inclusiveness of rules based on economic perspectives and argued that increased precision of rules would increase the efficiency of resource allocation. According to him, efficiency improvement through the increase of rule precision is achieved through two channels. The first is through direct impact on the actions of the regulatee. With precise rules, the regulatee have the tendency to believe that their undesirable behavior is easily detected and penalized. The second is lower enforcement cost, where higher probability of detection is achieved with the same regulatory resources. However, his argument that increasing the precision of rules would improve efficiency has a weakness. In the real world, the rule-maker cannot anticipate all contingent events and circumstances and thus the precise rule cannot deal efficiently with unexpected situations. He didn't sufficiently consider the social cost that can arise from rigid rule-making and rule-enforcing.

Baldwin was interested in the research of the effectiveness of rules.[308] He started with three questions: why rules fail to work; how might rules be designed so as to work more efficiently; and what is it that impedes the making of effective rules? He attempted to answer these questions through a case study of the health and safety regulation in the UK. Based on the case study, he made some important arguments. First, rules can have

[306] See section 1.5.1
[307] Isaac Ehrlich and Richard A. Posner, 'An economic analysis of legal rule-making' (n117)
[308] Robert Baldwin, 'Why rules don't work' [1990] 53.3 *The Modern Law Review* 321

many different shapes and forms and they can be combined with different enforcement strategies. Second, regulators should choose rule-types in accordance with their enforcement strategy. He argued that if rule-making takes into consideration enforcement, the unnecessary mistakes of informing the ill-intended or sanctioning the well-intended can be avoided. He explained that the reason that the rule-maker fails to consider the enforcement strategy as part of rule-making is because of their 'top-down' approach. The rule-maker tends to think that policy is made at the top while enforcement is done at the bottom of the organization and treat enforcement as an automatic chain of actions. Political constraints were also identified as another reason that the rule-maker fails to consider the enforcement strategy during rule-making. Internal politics in the regulatory agency and the political position of the regulatory agency can affect rule-makers. Such political consideration can result in the risk of rule-making supporting the value of a certain group or the taking of a defensive approach to regulation to obtain political support. Baldwin concluded with the comment that "[i]mproved rulemaking will come through paying regard to that issue[problem of top-down approach] rather than clinging to the notion that rules shape the world." His explanation about the top-down approach of rule-makers and political constraints as the cause of regulatory failure guided this thesis in analyzing the situation of South Korea.[309]

Black summarized the research results of many past scholars on the topic of the limitations of rules and suggested how the limitation may be overcome.[310] First she provided a framework for understanding rules' jurisprudential and linguistic characteristics and explained that those characteristics are the reasons for over- or under-inclusiveness and indeterminacy, which are inherent limitations of rules. Then she showed that because of such limitations, there is a trade-off relationship between flexibility and certainty in rulemaking. She pointed out that a specific rule can sometimes be counterproductive in achieving its goal and can induce creative compliance by the regulatee, but it is also difficult to define suitable standard of behavior with a vague rule. In the end, she presented three strategies for overcoming the limitation of rules: the use

[309] See chapter III and IV
[310] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997)

of different types of rules, building a community that has the same understanding about a rule, and enforcement based on conversation between the regulator and the regulatee. This thesis applied Black's three strategies to analyze the strengths and weaknesses of the COB regimes and used it as the baseline for recommending reform in South Korea.[311]

Although there are not many, some scholars discussed how to formulate the COB's specific requirements into a rule.[312] Blair talked about the ambiguity of the suitability requirement and explained that the lack of clear standards about unsuitable advice results in problems for the claimant in producing proof and also failure in creating a 'satisfactory prophylactic system'.[313] So he argued that objective assessment of suitability should be possible and suggested a method of measuring suitability that compares the appropriate risk level for the client and the risk of the advisor's recommendation: the comparison of Risk Quotient (RQ) to Client Appropriate Risk Level (CARL). He proposed that advice is suitable if the RQ is less than 1.0 and unsuitable if more than 2.0. However, the experience of South Korea shows that a mechanical approach in implementing suitability tends to have unexpected side-effects.[314]

Literature on rule-enforcing

Reiss classified enforcement strategies into deterrence-focused and compliance-focused enforcement and analyzed the condition in which each strategy is most effective.[315] A compliance-focused system induces conformity by providing an incentive towards a regulatory end and is appropriate when it is too complex or too costly to detect violation. A deterrence system is organized to detect violation and is chosen when the occurrence of the relevant event is unpredictable and the cause imperfectly understood. He argued

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311 See chapter III and IV

312 Michelle Lichtor, 'How Suitable is the Language of Suitability in the Modern Era' [2013] 39 *J. Corp. L.* 201 where the author pointed out the ambuguous meaning of suitability in the US and recommended to just put fiduciary duty on broker-dealers instead of suitability.

313 Blair H. Wallace, 'A Proposal to Refine the Suitability Standard by Quantifying Recommendation Risk and Client Appropriate Risk Levels' [2006] 1 *Brook. J. Corp. Fin. & Com. L.* 231

314 See p 1 2 8

315 Albert J. Reiss, 'Selecting Strategies of Social Control over Organizational Life' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984)

that the deterrence system is generally ineffective because the penalties to wrongdoers don't have a direct impact on them and instead can be transferred to others. Also, in modern society where the method of social control is shifting from "direct observation and intervention" to "trust", the compliance system in general creates better results. Still, he pointed out that because the trust relationship is fragile to intended breach of the agreement, enforcement institutions that are founded on mistrust and distrust are inevitable. In other words, the appropriate enforcement strategy varies depending on the level of trust in a society. The categorization and analysis of enforcement strategies provided by Reiss was used as the basis for the framework for analyzing COB enforcement in the UK and South Korea in this thesis. [316]

Fenn and Veljanovski developed a positive theory about public enforcement through an economic model.[317] Their model explained that the regulatory agency uses not only legal enforcement devices such as fines but also extra-legal tools such as bargaining and even selective non-enforcement. The model provided economic explanations of why regulatory agencies use discretion not to choose legal processes for enforcement. They pointed out that the use of discretion by the regulator in the enforcement process isn't something that is captured but a rational response with an economic basis. This implies that limiting the regulator to only legalistic enforcement without using discretion incurs social economic loss, which is the situation described in this thesis about South Korea.

Bardach and Kagan focused on problems of legalistic enforcement using the term "regulatory unreasonableness". [318] They argued that regulatory unreasonableness was caused by both "stringent regulation" and "aggressive and strict enforcement". According to them, even though regulators' sanctioning power was strengthened, the room of their discretion was reduced in the US. They contended that by compelling both regulators and the regulated to "go by the book", regulation isn't enforced as flexibly as circumstances need. Legalistic approach in enforcement, they added, can cause resentful

[316] See section 1.5.1.2

[317] Paul Fenn, and Cento G. Veljanovski, 'A Positive Economic Theory of Regulatory Enforcement' [1988] 98.393 *The Economic Journal* 1055

[318] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (Transaction Publishers, 1982)

and uncooperative attitude among the regulated. In order to solve the regulatory unreasonableness, they suggested that enforcers should converse with the regulatee to change the adversary relationship between the regulator and the regulatee. Enforcers should have open-minded conversation with the regulatee to help them comply with regulatory requirements in more efficient ways. For this, Bardach and Kagan argued that the agency should design a proper incentive structure to induce its managers and enforcers to implement the regulation *reasonably*. Bardach and Kagan's analysis about the legalistic approach to regulation helped the thesis to explain the problems of rigid rule-making and rule-enforcing in South Korea.[319]

Vogel comprehensively analyzed the environmental regulation in the UK and the US using a comparative methodology.[320] According to his analysis, the US regulation is adversarial, litigious and rule-based while the UK regulation is cooperative and consensual and leaves a lot of room for regulator's discretion. He explained that in the UK, the regulatory agency alone makes the regulatory decisions based on the agreement with the industry in a form of negotiated compromise but, he added that, there is significant reliance on the industry's self-regulation in implementing the regulatory decisions. In contrast, he said that in the US, the central agency is responsible for implementation, with almost no reliance on self-regulation. He noted that the advantage of the UK's negotiated regulatory resolution is that the regulated are more committed to the regulatory resolution. According to him, while the US environmental regulation is stricter, the UK regulation is more flexible and faster in handling new risks. Based on such analysis, Vogel argued that the UK regulation model is more successful because there is higher acceptance by the regulatee, less political conflict and less waste of resources for prosecution and litigation. He also argued that the UK regulation can be less open and democratic but more flexible and efficient in achieving the regulatory goal; and he extended this conclusion to other regulatory areas, such as health and safety, antitrust,

[319] See section 4.2.3
[320] David Vogel, *National Styles of Regulation (*Cornel University Press, 1986)

securities and banking. Vogel's analysis of the UK's regulatory culture is very similar to the culture of UK financial regulation as found in this thesis.[321]

Instead of the dichotomy of deterrence or compliance, Ayres and Braithwaite advocated responsive regulation, which is a tailor-made approach to enforcement.[322] Under responsive regulation, the enforcer escalates the intervention up or deregulate down depending on the regulatory performance of the regulated. The concept of responsive regulation has had a big impact in the academia, but it isn't clear how it works in the real world. The first reason is that, for the regulatees who are ill-intended towards regulation, low level enforcement such as persuasion can provide the opportunity and time for evasion. This can be the reason why the UK's light-touch approach has failed.[323] Another problem with applying responsive regulation is that the regulatees continue to change. Individual executives and the business strategies of a firm are not fixed but frequently changed. Alleviated enforcement would be applied to a firm that shows good regulatory performance but the quality of the regulatory performance can change at any time with changes to the company's executives and strategy.

Parker warned that deterrence-oriented enforcement and compliance-oriented enforcement can fall into the deterrence trap and the compliance trap, respectively.[324] The deterrence trap refers to the inability of "simple deterrence" to produce commitment to compliance because it cannot change the morality of the regulated. To overcome the deterrence trap, he said that the deterrence impact must be "leveraged" with moral judgements. But he added that unless there is political support for regulatory action, the approach of leveraging deterrence with morality falls into a compliance trap. Under the compliance trap, he explained that the regulated who breach regulation will maintain that moral leveraging is unfair and lobby to a political party and in such a case, there is higher possibility that regulators will avoid conflicts through soft enforcement. He

[321] See section 4.1.3

[322] Ian Ayres and John Braithwaite, *Responsive regulation: Transcending the deregulation debate* (Oxford University Press on Demand, 1992)

[323] See p 1 7 6

[324] Christine Parker, 'The ''Compliance'' Trap: The Moral Message in Responsive Regulatory Enforcement' (2006) 40.3 *Law & Society Review* 591

concluded that it would be a more successful enforcement strategy for the regulator to promote compliance with a wider range of sanctions. Parker's deterrence trap and compliance trap theory well explains the problems of the UK's COB regime.[325]

Hodge argued that considering public enforcement and internal management as alternatives is wrong and that their combination is most effective.[326] He noted that exclusive reliance on external regulatory enforcement represents failure in utilizing the more extensive management and compliance system inside corporations. He explained that the ability of regulated firms to influence the behaviour of employees and of other members in the industry is significant in achieving regulatory goals. He empirically showed that in many EU countries, the regulatory system is designed so that internal and external regulatory enforcement is collectively operated. Hodge's argument provided theoretical support for this thesis to recommend that the COB regime of South Korea be changed from the command-and-control style to decentred regulation.[327]

Yeung had the objective of developing a normative framework for public enforcement through the case study of Austrian competition law.[328] She had a viewpoint that enforcement tactics like negotiation can facilitate regulatory goals such as flexibility and responsiveness but can undermine constitutional values such as due process, transparency, proportionality and consistency. She insisted on a "principled approach" that pursues both regulatory goals and constitutional values. Such a normative framework, she added, can be applied to all the stages of regulation such as regulatory institutional design, standard setting and evaluation of regulatory regime. However, she also pointed out that the "principled approach" cannot provide a pre-setting solution but conflicts between regulatory goals and constitutional values should be solved depending on circumstances of each situation. Based on Yeung's theory, the thesis recognizes that

[325] See section 4.1.3

[326] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*2015)

[327] See p 2 2 4

[328] Karen Yeung, *Securing Compliance: A Principled Approach (*Hart Publishing, 2004)

the suggestion made for improving the effectiveness of the Korean COB regime can be in conflicts with constitutional values.[329]

Pistor and Xu talked about optimal law-making and law-enforcing with the assumption that law is inherently incomplete.[330] They explained that Law must be applied to many cases over a long period of time so must have generality but that the generality makes it impossible for law to have completeness. They added that the incompleteness of law demands the allocation of law-making power among the legislator, the court and the regulators and that optimal allocation is determined based on three factors: the possibility of whether the action that causes harm to society can be standardized, the speed of socioeconomic and technological change and cost of regulation. They argued that because of the incompleteness, enforcement by only the court is insufficient and the regulator must perform a different function of enforcement; the regulator's big advantage compared to the court is that it can initiate intervention and action. For a regulatory regime to be effective, they argued that a well-designed system of allocating law-making and law-enforcing power is needed. This argument is similar to Schauer's argument that rules are the device with which rule-making and rule-enforcing authority is allocated.[331] When Pistor and Xu applied their theory on the UK, US and German financial markets, they found that the need for the regulator's flexible law-making and proactive enforcement isn't limited to certain jurisdictions and without it, the development of the capital market is negatively impacted in the long-term. Their theory provides theoretic support for the argument made in this thesis that harmonized interplay between public enforcement and private enforcement is required. [332]

Although not many, some scholars have done specialized research on COB enforcement. Moloney did research on the effectiveness of regulation with a focus on the COB.[333] She

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[329] See p268

[330] Katharina Pistor, and Chenggang Xu, 'Incomplete law' (2002) 35 *NYUJ Int'l L. & Pol.* 932,

[331] See p 5 1

[332] See section 5.3

[333] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010)

pointed out the failure of the UK FSA's "Treating Customers Fairly" and questioned whether COB can change the practice of advice or distribution. She also argued that there is a limit to how much "law on the books" can change marketing and communication practices and that more regulatory action with extensive regulatory resources are needed to implement abstract requirements like suitability and fair communication. Regarding to the "fair communication" requirement of COB, she noted that a comprehensive fairness obligation is useful for achieving effective investor protection in "law in action" but because of the divergent and unpredictable *ex-post* interpretation, innovative attempts in distribution and advice industry are threatened. She also pointed out that the suitability rule "on the books" appears to promise better quality of advice but that without strong quality of enforcement, the intended outcome cannot be achieved. This argument is similar to the argument made by the thesis that the South Korean and the UK regulatory regime needs a "balanced enforcement".[334]

Hudson called for the synthesizing of public regulation and private law in the COB.[335] He stated that the court is intentionally ignoring the positive obligations put on the financial institutions by financial regulation and is bounding itself to the norm of contract law and tort law that customers must protect themselves in the process of contractual negotiation. His suggestion was that when the court decides liability, it should use the regulatory standards like COB as decision-making criteria. Consistent to Hudson's suggestion, the thesis recommends that the UK should widen the extent that the COBS binds the court to achieve more complementary interplay between public enforcement and private enforcement.[336]

Tuch's research was about the problems of the US COB regime.[337] He pointed out that the legal framework of the US COB regime is too complex: COB is defined in dispersed sources like the federal and state statutes, the rules of federal and state regulators, rules

[334] See section 4.3.3
[335] Alaistar Hudson, 'The synthesis of public and private in finance law' in Barker, Kit, and Darryn Jensen (eds), *Private law: key encounters with public law* (Cambridge University Press 2013)
[336] See section 6.3.1
[337] Andrew F. Tuch, 'Conduct of Business Regulation' in Niamh Moloney et al. *Oxford Handbook of Financial Regulation (*2015)

and interpretations of self-regulators and formal and informal pronouncements of regulators. On top of the complex legal framework, there is another problem of different regulatory requirements applying to investment advisors and broker-dealers who perform the same role of investment recommendation. His research includes deep analysis about the problems of the US COB framework but is limited in that it hardly touches on the enforcement.

Ferran reviewed 'mis-selling' of payment protection insurance (hereafter "PPI") which was a big social issue in the UK and provided practical solutions to curb the chronic mis-selling in the UK.[338] First, she proposed the rebalancing of principles and descriptive rules in the rulebook. She argued that some of the specific rigid rules should be adopted as prophylactic measures. Second, she called for tough formal enforcement to achieve credible deterrence, explaining that the fine was too small compared to the consumer damage in the PPI mis-selling. Third, she maintained that in the PPI mis-selling redress process, the regulator had "over-estimation of industry's self-interest in treating customers fairly". Her second and third points have much similarity to the "balanced enforcement" as argued in the thesis but in respect to her first point, the thesis refutes it based on the side-effects of the rigid rulemaking system in Korea.[339]

South Korea

In South Korea, research on COB was scarce and indeed only after the huge social issue related to KIKO was there any research even discussing the court's decisions in the KIKO disputes. But even then, such discussions were focused on criticizing the court's decision and no thesis could be found which aimed to analyze the causes of the regulatory failure. The first reason that research on COB has been lacking in South Korea is due to its academic community's 'disportionate' focus on prudential regulation.[340] In the late 1990s local major banks in the country suffered insolvency and the shock of the experience

[338] Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance 'mis-selling' Scandal in the UK' [2012] 13.2 *European Business Organization Law Review* 247

[339] See section 3.4.1

[340] Hong Junhyung, 'Legal structure of financial regulation and reform' (2001) 1 *Korean Comparative Public Law Association,* 107, 109-110

made concerns as to efficacy of COB for investor protection appear trivial compared to prudential regulation.[341] The second reason for the lack of research on COB from a regulatory perspective is that legal scholars have seen COB as first and foremost a topic of concern for private law. This can be the reason why legal research on COB even after the KIKO scandal has focused on case law as opposed to considering questions of substantive regulatory design and enforcement.[342]

Kim Youngjae argued that KIKO was designed originally unfair and unbalanced in terms of product structure itself.[343] From the opposite side, Gene Soon Park insisted that the fundamental cause of the KIKO controversy was the abrupt rise of foreign exchange rates, which no one had foreseen.[344] So he argued that it was undesirable to transfer the consequence of the rise of foreign exchange rates to banks through litigations.

There has been a small amount of work that theoretically approached the 'mis-selling' of financial instruments. Kwon Sun-il analyzed the statutory regulation and private law before the Korean FISCM Act on investment recommendation. [345] He explained that the statues and related regulation on securities transactions put administrative penalty and criminal charge but don't include civil compensation provisions. He also criticized the lack of robustness in the public enforcement of contraventions of these statutes and regulation. He showed that such regulatory loopholes are filled by general private law such as civil law and commercial law. He also explored the concept and theoretical basis of "duty to protect customers" established by private law in relation to investment recommendations. However, he excluded the topic of how to improve public enforcement from his thesis so there is the limitation that the research was done only on the law on the books.

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[341] Ibid

[342] Seung-Pil Choi, 'Interpretation of Banking Regulation with a Perspective on Public Law - Based on Issues of Banking Act for Establishment of Financial Administrative Law' (2016) 17.1 *Korean Comparative Public Law Association*, 301, 303

[343] Kim Youngjae, 'Reconsidering Lower Courts' Decisions on KIKO Cases' [2013] 41.41 *Anam Law* 159

[344] Gene Soon Park, 'Summary and Analysis of KIKO Trial Rulings' [2011] 8.1 *Korea Finance Law*, 3

[345] Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender]* (Parkyoungsa, 2000)

1.5 Originality of the thesis

Although there has been much research done on the general theories of regulatory rule-making and rule-enforcing, as Pizzolla stated[346], there is a significant lack of comparative law research on financial regulation and almost none specializing on COB. The thesis applies the accumulated theories of comparative law and regulations to COB to analyse the causes of regulatory failure and to suggest ways for improvement. Through this process, the validity of existing regulatory theories can also be tested. Moreover, the thesis has the potential to make a significant contribution to academic literature in South Korea where almost no analysis has been done about the failure of the COB regime and the causes.

1.6 Structure of the thesis

In order to answer the first research question,[347] a degree of understanding about products transacted, markets' participants, and the practice of transactions is required, and so chapter II examines basic derivative products such as options and also the nature of the more complicated over-the-counter derivative products. Next, the chapter analyses the nature and characteristics of different groups of participants in the over-the-counter markets. This analysis shows why end-users depend on the financial institutions. An examination of transactional practices then explains the conflicts of interest between the financial institutions, their sales representatives, and end-users.

Chapter III examines the development process of the overall structure of financial regulation of the UK and South Korea and how COB is positioned within each structure. The chapter also looks at the constitution of each country as it puts limits on the rulemaking method. The process of how the financial regulatory system in each of the two countries has come to be shaped is explained with historical and constitutional context. This provides the foundation for highlighting the difference between the

[346] See p296

[347] "What are the characteristics of over-the-counter derivatives which make them more vulnerable to "mis-selling" than other financial instruments?"

rulemaking systems of the two countries. The next step in the analysis is to look at the regulatory rules of the two countries that address the key causes of 'mis-selling', which are information asymmetry and bounded rationality of consumers. A comparison is made of how the two countries developed rules to solve the same problem and evaluation is made of how effective the rulemaking method is in achieving the regulatory objective, which partly answers the third research question.[348] And then the institutional and cultural factors that influence each country's rulemaking method is explained.

Chapter IV examines public enforcement cases in the UK and South Korea in order to identify each country's enforcement strategy. The chapter then analyses the regulatory outcomes of the two countries' diverging enforcement strategies. By conducting a causal analysis of these strategies and the regulatory outcomes, the chapter provides an answer to the other part of the third research question.

Chapter V analyses the disputes in court about the 'mis-selling' of over-the-counter derivatives. The case-studies enable an understanding of the principles which private law applies to 'mis-selling' disputes. It also sheds light on the different institutional designs which define the relationship between COB and private law. Then, the chapter examines why there are two different legal institutions: statutory regulation and private law. Then the chapter provides analysis about whether private enforcement and public enforcement in the two countries complement each other's weaknesses, which answers the fourth research question.[349]

Finally, chapter VI summarizes the finding of the thesis and explains the contribution it makes and makes suggestions for reform to improve the effectiveness of COB regime in South Korea and the UK.

[348] "What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?"

[349] "How did South Korea and the UK design the relationship between private law and the COB and as a result, do public enforcement and private enforcement interplay effectively in the COB regimes of the two countries?"

II. THE OVER-THE-COUNTER DERIVATIVES MARKETS

Introduction

The aim of the chapter is to develop an understanding of over-the-counter derivatives and the markets in which they are transacted, so as to answer the first research question.[350]

First, the chapter contains a conceptual analysis of derivative products. This analysis includes the basic components of derivatives, such as options and forwards, as well as structured products, which have gained popularity among investors. Thereafter, the market for derivatives is examined through a brief look at the exchange market, followed by a more in-depth analysis of the over-the-counter market. The analysis will consider the nature of products transacted and participants involved in the markets, as well as financial institutions' marketing strategy for over-the-counter derivatives. Based on these analyses, the market characteristics and their implications for the subsequent discussions in the thesis will be identified.

Second, the chapter considers over-the-counter derivatives through the lens of the law. The perspectives of private law, as well as the financial regulation of transactions of over-the-counter derivatives, will be considered.

2.1 Derivative products

2.1.1 Concept of derivatives

A common definition of a derivative is 'a financial instrument, whose values derive from underlying variables.'[351] Underlying variables could be the values of other assets or liabilities. Derivatives in simple forms have been used for thousands of years.[352] In

[350] "What are the characteristics of over-the-counter derivatives which make them more vulnerable to "mis-selling" than other financial instruments?"

[351] John C Hull, *Options, futures, and other derivatives* (Pearson Education India 2006) 1

[352] Rasiah Gengatharen, *Derivatives law and regulation* (Vol. 20. Kluwer Law International 2001) 8-12; Roberta Romano, 'Thumbnail Sketch of Derivative Securities and Their Regulation' (1996) 55 Md. L. Rev. 7, 40-41

modern times, their extensive use started in the early 1970s when Bretton Woods system, which fixed currency rates, was abandoned.[353]

There are two basic categories of derivatives: options and forwards.[354] All derivatives consist of more than one of these two basic components.[355] Options are the right to buy or sell a certain underlying asset at a certain price. Additional conditions such as a cap, floor, or collar can be added to the basic options.[356]

A forward is an agreement where a buyer and a seller agree to transact a certain underlying asset on a specified date at a specified price. A swap is an agreement to exchange future cash flows and can be described as a series of forwards. A large variety of derivatives can be created using the above basic components.

The term 'structured products' describes cash assets such as bonds, that are combined with derivatives to provide a pay-off not otherwise available.[357] These products were created to satisfy investors' diverse risk-return objectives and have become popular as alternative investments since the 2000s.[358] Structured products include structured notes, which are debt securities embedded with a derivative.[359]

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[353] Willa E Gibson, 'Investors, Look before You Leap: The Suitability Doctrine Isn't Suitable for OTC Derivatives Dealers' (1997) *29 Loy. U. Chi. LJ* 527, 532; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (1994) 73 *Tex. L. Rev.* 985, 1011

[354] GROUP OF THIRTY, 'GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 29' (1993) 27 available at <group30.org/images/uploads/publications/G30_Derivatives-Surveys.pdf> accessed 6th October 2017

[355] Ibid

[356] A cap places a ceiling on the price of the underlying asset and protects, for instance, float rate borrowers from interest rate increases. A floor sets a minimum price at which to sell an underlying asset, and protects a seller from a price decline. A collar holds a cap and a floor, and so restricts the price movement within a certain band.

[357] Robert W Kolb and Overdahl James A, *Financial derivatives: pricing and risk management* (Vol. 5, John Wiley & Sons 2010) 6

[358] Timoth A. Day, 'Structured products' in Tanya S. Beder and Cara M. Marshall, *Financial Engineering: The Evolution of Profession* (1 edition, John Wiley & Sons 2011) 260-261

[359] Carolyn H Jackson, 'Have You Hedged Today--The Inevitable Advent of Consumer Derivatives' (1998) *67 Fordham L. Rev.* 3205, 3224-3225, which described the first advent of structured products; see also Financial Conduct Authority, 'Structured Products: Thematic Review of Product Development and Governance' (2015) 25-26, which explains that debt securities embedded with a derivative includes (1)structured capital-at-risk investment products (SCARPs) are instruments whose return is based on a pre-set formula connected to the movement of other variables such as an equity index, but where the principal of the investment can be lost; (2) non-SCARPs have the same pay-off structure as the SCARPs, but their investment principal is protected as long

2.2 Derivative markets

Derivatives can be transacted in two different markets: exchanges and over-the-counter markets. Exchange markets list standardized derivatives such as futures and options, which have pre-set terms of maturity and strike price. In over-the-counter derivative markets, customized derivatives are bilaterally transacted.

2.2.1 Exchange markets

The organised exchange markets for derivatives transactions emerged in the mid-1800s in Chicago.[360] Their clearinghouse function rendered these markets free from the credit risks of counterparties[361]; they were cost-effective in searching counterparties for transactions[362]; and they had better price transparency[363]. However, exchange markets have a critical limitation: inflexibility of product structure and contractual terms.[364] While standardization of derivatives can reduce transaction costs, this inflexibility makes it difficult for investors to tailor derivatives to their specific needs.[365]

In the real business world, investors cannot find standardized derivatives fully fitting their needs due to the mismatch of maturity and amounts.[366] This mismatch problem is of critical concern, particularly for investors using derivatives as hedge against a risk. For hedge accounting to be applied, the International Accounting Standards[367] and U.S.

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as the issuer of the non-SCARPs is solvent; and (3)structured deposits are deposits whose interest is linked with the performance of other indices or assets.

[360] Robert W. Kolb and James A. Overdahl, *Financial Derivatives (*3rd edition, Wiley 2003) 4

[361] Ibid 17

[362] Ibid

[363] Michael Chui, 'Derivatives markets, products and participants: an overview' (2010) China and the Irving Fisher Committee in Zhengzhou on 27–29 September 2010, 9

[364] Robert W. Kolb and James (n 360) 18

[365] Aaron L. Philip, '1995 Derivatives Practices and Instruments Survey' (1995) 24.2 *Financial Management* 115,123; for instance, suppose a British company—which has receivables of $1.5 million from its foreign importer at the end of February—needs to hedge its foreign exchange rate risk. Exchange-traded derivatives such as futures and options may only reach maturity at the end of January and have a contract unit amount of $1 million. With such standardized derivatives, this company cannot fully hedge its foreign exchange rate risk due to the mismatch of maturity and amounts.

[366] Federal Reserve Bank of Chicago, 'Understanding Derivatives-Markets and Infrastructures' (2014) 27-28 available at <file:///C:/Users/Hoon/Downloads/understanding-derivatives-chapter-1-derivatives-overview-pdf.pdf> accessed 6th October 2017

[367] International Accounting Standards 39

GAAP[368] require hedging products to have sufficient offsetting effects on the value movement of the hedged assets.[369]

2.2.2 Over-the-counter markets

The tight regulation of derivative trading in exchange market reduces the risk of disputes;[370] product structure and features are simple and transparent, and repeat end-users are familiar with the standardized products. This thesis will therefore focus on the over-the-counter markets.

Flexibility is one of the distinguishing characteristics of over-the-counter markets.[371] In these markets, two counterparties can agree to trade any type of derivative through a limitless range of contractual structures. This flexibility is the primary enabler of risk hedging in the business world. Companies manage their own specific business risks with over-the-counter derivatives in a more robust manner, which isn't possible with standardized derivatives.[372] Such flexibility has led to growth in market scale.[373]

2.2.2.1 Products transacted

Theoretically, anything quantifiable can be used as an underlying asset of over-the-counter derivatives.[374] However, these markets can be classified into the following major

[368] Financial Accounting Standard 133

[369] This means that a derivative product that doesn't have a sufficient offsetting effect against the hedged asset cannot be recognized as a hedge in investors' financial statements.

[370] Aaron L. Philip (n 365) 123

[371] Ibid

[372] COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES, 'The Effective Regulation of the Over-the-Counter Derivatives Market: Hearing Before the Sub comm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H.Comm. on Financial Services', (111th Cong.164, 2009) 18, available at <https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg52397/pdf/CHRG-111hhrg52397.pdf > accessed 20 July 2016

[373] Bank For International Settlement, 'Semiannual OTC derivatives statistics' table D5, available at < http://www.bis.org/statistics/derstats.htm> accessed 15 March 2016; as of June 2015, the global notional outstanding amount of over-the-counter derivatives was $553 trillion—almost nine times the exchange-traded derivatives market volume of $63 trillion.

[374] Mark A Guinn and Harvey William L, 'Taking OTC Derivative Contracts as Collateral' [2002] *The Business Lawyer* 1127, 1129

sub-markets: interest rate products, foreign exchange products, credit default swaps, equity derivatives.[375]

Most[376] of the over-the-counter derivatives are effected through contracts by the standard documentation created by the International Swaps and Derivatives Association ("ISDA"), which was organized in 1985 by major financial institutions to facilitate over-the-counter derivatives transactions.[377] These documents include all the necessary provisions for enhancing certainty of transactions, including the obligations and representations of each party.[378]

2.2.2.2 Participants

Participants in over-the-counter derivatives markets can be classified into two groups: dealers and end-users. Dealers are major financial institutions that sell over-the-counter derivatives to end-users.[379] Dealers become the counterparties of end-users and earn commission, which equates to the gap between the bid and ask prices.[380] The difference between bid and ask prices is determined by the amount of information that the end-user has about the prices of other transactions in the market.[381] Opaqueness of price can therefore enhance the profitability of dealers.[382]

Dealers themselves use highly sophisticated risk management methodologies to hedge the risk derived from the position of derivatives transactions with end-users, in order to

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[375] Bank For International Settlement (n 373); interest rate products with $435 trillion of notional amounts as of June 2015 (same as below), foreign exchange products with $75 trillion, credit default swaps with $15 trillion, equity derivatives with $8 trillion, commodity derivatives with $2 trillion, and others with $20 trillion.

[376] Joanne P Braithwaite, 'OTC derivatives, the courts and regulatory reform' (2012) 7.4 *Capital Markets Law Journal* 364, n10, which explained that "the ISDA Master Agreement which serves as the contractual foundation for more than 90% of derivatives transactions globally."

[377] Frank Partnoy, 'ISDA, NASD, CFMA, and SDNY: the four horsemen of derivatives regulation?' (2002) *Brookings-Wharton Papers on Financial Services* 2002, 213, 217-218

[378] Ibid

[379] Kojima J. Christopher, 'Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying the Federal Securities Laws to OTC Derivatives' (1995) 33 *AM. Bus. L.J.* 259, 266

[380] Willa E Gibson, 'Investors, Look before You Leap: The Suitability Doctrine Isn't Suitable for OTC Derivatives Dealers' (1997) 29 *Loy. U. Chi. LJ* 527,539

[381] Darrell Duffie, *Dark Markets: Asset Pricing and Information Transmission in Over-the Counter Markets* (Princeton: Princeton University Press 2012) 5

[382] Ibid

be insulated from market movements.[383] When conducting hedging transactions of over-the-counter derivatives, dealers become end-users.[384] Financial institutions can therefore be dealers and end-users, depending on the purpose of the transaction.[385]

End-users enter into over-the-counter derivatives contracts for hedge or investment purposes, not for commission.[386] Based on outstanding volume, the majority of end-users are financial institutions.[387] The latter are exposed to various financial risks.[388] Risk management is therefore their core business activity.[389]

Similarly, non-financial companies have many reasons to use over-the-counter derivatives. First, they can reduce the business volatility resulting from macroeconomic variables by using over-the-counter derivatives: exporters or importers hedge foreign exchange rate risk; corporations protect the worth of assets and liability; and manufacturers stabilize the cost of raw materials. Empirical research has shown that hedging enables stable corporate financial performance and enhances firm value.[390] A survey of the ISDA has shown that 94% of the world's 500 largest companies,[391] and 62% of the UK's non-financial listed companies,[392] use derivatives to hedge or manage their business risk.

Many SMEs also enter into over-the-counter derivatives contracts. While lack of expertise, and resources is obstacles to the use of over-the-counter derivatives for SMEs,[393] their reasons for using over-the-counter derivatives are the same as those of large

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[383] Ibid 540; GROUP OF THIRTY (n 354) 39-40
[384] Darrell Duffie (n 381) 8
[385] Ibid
[386] GROUP OF THIRTY (n354) 32-36
[387] Bank For International Settlement (n 373)
[388] GROUP OF THIRTY (n354) 38-39
[389] John Hull, *Risk Management and Financial Institutions, + Web Site*, (Vol. 733, John Wiley & Sons 2012)
[390] See eg Söhnke M Bartram, Brown Gregory W, and Fehle Frank R, 'International evidence on financial derivatives usage' (2003) 27, <https://www.researchgate.net/profile/Soehnke_Bartram/publication/23743525_International_Evidence_on_Financial_Derivatives_Usage/links/0fcfd50bad2b7da781000000.pdf> accessed 10 March 2016
[391] International Swaps and Derivatives Association, 'Over 94% of the World's Largest Companies Use Derivatives to Help Manage Their Risks, According to ISDA Survey' (2009) 1, available at <www.isda.org/press/press042309der.pdf> accessed March 2016
[392] Chris Mallin, Kean Ow-Yong, and Martin Reynolds, 'Derivatives usage in UK non-financial listed companies' (2001) 7.1 *The European Journal of Finance* 63,68
[393] Joost ME Pennings and Philip Garcia, 'Hedging behavior in small and medium-sized enterprises: The role of unobserved heterogeneity' (2004) 28.5 *Journal of Banking & Finance* 951,955-957

corporations. A 2014 empirical study revealed that 24% of the UK's listed non-financial SMEs used over-the-counter derivatives.[394]

An important trend among individual investors is the increasing investment in structured products embedded with over-the-counter derivatives. Disappointed by low interest rates from ordinary savings products, individual investors seek the better returns, while at the same time protecting their investment principal.[395] Structured products—which purport to protect against the risk of losing principal and provide higher income than ordinary savings—have met this demand.[396]

Expansion of the user base of over-the-counter derivatives to SMEs and individual investors has been largely triggered by supply-side innovation.[397] Risk management techniques have progressed dramatically since the 1990s, enabling dealers to tailor derivatives transactions to each end-user.[398] This innovation has been accelerated by the race among financial institutions to be 'one step ahead of the competition.'[399]

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[394] Giulia Fantini, *Financial A Empirical evidence from UK & Italian non-financial firms* (Diss. Università degli Studi di Ferrara, 2014) 52-53

[395] See eg Financial Services Authority, 'Retail Conduct Risk Outlook' (2011) 47-51 <http://www.fsa.gov.uk/pubs/other/rcro.pdf> accessed March 2016

[396] Retail investment in structured products has grown sufficiently to attract the financial regulator's attention. See Financial Services Authority, 'Retail Product Development and Governance-Structured Products Review' (2011) available at <https://www.fca.org.uk/publication/finalised-guidance/fg12-09.pdf> ; Financial Conduct Authority, 'Structured Products: Thematic Review of Product Development and Governance' (2015) available at <https://www.fca.org.uk/publications/thematic-reviews/tr15-2-structured-products-thematic-review-product-development-and> accessed 6th October 2017; Alex Erskine, 'Retail derivatives: What we know, what we don't know, and regulatory challenges' [2011] 4 *JASSA*, 55

[397] Dan Awrey, 'Toward a supply-side theory of financial innovation' (2012) 23-39 < http://ineteconomics.org/uploads/papers/Awrey-Paper.pdf> accessed November 2015; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (n353) n13; Robert W Kolb and Overdahl James A, *Financial derivatives: pricing and risk management* (n357) 221-230; Carolyn H Jackson (n 359) 3260; new products have been developed, such as economic derivatives, for entities whose income—for example tax revenue of the government—closely correlates with growth of the economy. Real estate derivatives have been also developed for investors who want to hedge their investment in real estate.

[398] Bruce G Carruthers, 'Diverging derivatives: Law, governance and modern financial markets' (2013), 13 <http://blogs.law.columbia.edu/glawfin/files/2013/10/09-Diverging-Derivatives.-Law-Governance-and-Modern-Financial-Markets-by-Bruce-G.-Carruthers.pdf> accessed November 2015; GROUP OF THIRTY (n354) 39-40

[399] Peter Tufano, 'Financial Innovation and First Mover Advantages' (1989) 25 Journal of Financial Economics 213, 225-234; see also *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481-482 where the financial institution developed a new type of SCARP, so-called PEARLS, ahead of its rivals and could hold many clients.

The level of knowledge and experience in over-the-counter derivatives markets diverges tremendously between financial institutions and other end-users. Financial institutions have sufficient resources to expertly manage over-the-counter derivatives transactions. Prudential regulation also ensures that regulated financial institutions hold sufficient risk management capability.[400] Therefore, in over-the-counter derivatives transactions, financial institutions cannot be considered consumers, but counterparties.[401]

On the contrary, in the non-financial sector even large corporations usually don't have designated departments for over-the-counter derivatives transactions, and less so SMEs. Their only choice is substantial dependence on dealers for an understanding of nature and risks of over-the-counter derivatives.[402] A survey of UK-listed companies showed that the biggest concerns in derivative transacting were the difficulty of risk evaluation and the lack of knowledge.[403] In recognition of this clear difference in expertise, this thesis hereafter uses the term 'consumers'[404] to include non-financial corporations and individuals in over-the-counter derivatives transactions—arguing that this wider-than-common use of the term is justified by the complexity and nature of over-the-counter products.

2.2.2.3 Marketing

In over-the-counter derivatives markets, financial institutions use relationship marketing,[405] which aims to maximize long-term profits by solidifying relationships with clients, rather than by focusing on short-term or individual transaction profits.[406] Financial institutions designate an account manager charged with developing customer-

[400] John Hull (n 389) 19
[401] FCA Handbook, Conduct of Business Sourcebook ("COBS") 3.6.2R
[402] Alessio M. Pacces, 'Financial intermediation in the securities markets law and economics of COB' (2000) 20.4 *International Review of Law and Economics* 479, 482
[403] Chris Mallin, Kean Ow-Yong, and Martin Reynolds, 'Derivatives usage in UK non-financial listed companies' (2001) 7.1 *The European Journal of Finance* 63,77
[404] For more discussion about the term, "consumer", see Rossella Incardona and Cristina Poncibo, 'The average consumer, the unfair commercial practices directive, and the cognitive revolution' (2007) 30 *J. Consum. Policy.* 21, 21-26
[405] Katherine Tyler and Edmund Stanley, 'Marketing OTC equity derivatives: the role of relationships' (2002) 20.2 *International Journal of Bank Marketing* 67, 72-73
[406] Elizabeth Sheedy, 'Marketing derivatives: a question of trust' (1997) 15.1 *International Journal of Bank Marketing* 22, 22

relationships and facilitating the sales of a broad range of products, including over-the-counter derivatives.[407] Since over-the-counter derivatives are usually complex and large scale, a good relationship with consumers is seen as a prerequisite for undertaking transactions.[408] In order to obtain trust from their clients, account managers should expend significant efforts to demonstrate that they are interested in a long-term relationship.[409]

Financial institutions also try to enhance internal marketing in their organizations.[410] Marketers recognize their consumers' needs and business opportunities and sell their findings to derivatives engineers in their organizations.[411] This internal marketing process enables financial institutions to develop over-the-counter derivatives products that better meet the needs of each consumer.

2.2.3 Characteristics of over-the-counter derivatives markets

Considering the above analysis of over-the-counter derivatives markets, these markets are deemed to create conditions which make 'mis-selling' disputes occur easily.[412] First, Consumers, when they enter into over-the-counter derivatives contracts, rely on sales representatives to help them achieve their hedging or investment objectives. Unlike standardized instruments such as shares or debentures, over-the-counter derivatives need to be newly designed to fit the objectives of the individual investor so his dependency on a financial institution is inevitable. Second, self-induced or hierarchical pressure for sales performance can give rise to marketing practices that are blind to the real consumer benefits. On top of these, the high leverage used in over-the-counter derivatives makes the loss can increase exponentially when market moves unexpectedly.

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[407] Ibid
[408] Ibid 26
[409] Katherine Tyler (n 405) 71
[410] N. S. Nilakantan, 'Marketing of Derivatives in the Aftermath of Lehman Crisis' (2010) 8.2 *Synergy* 43, 47
[411] Ibid
[412] The term 'mis-selling' is often used to imply that consumers have been somehow misled into buying products. See Oxford dictionary <http://www.oxforddictionaries.com/definition/english/mis-sell?q=mis+selling> accessed March 2016

When suffering loss from unexpected market movements, consumers who have relied on sales representatives' explanations are likely to think that they were misled to enter into over-the-counter derivatives. This is the typical scenario of how 'mis-selling' disputes arise in over-the-counter derivatives markets. The structure of the market and the nature of participants create the perfect environment for such disputes.

2.3 Legal perspectives of derivatives transactions

Previous sections have analysed over-the-counter derivatives markets from economic angles. The following sections will examine derivatives from legal perspectives and identify legal risks in transacting them.

2.3.1 Legal concepts of derivatives

From the perspective of private law, a derivative transaction is a contract that creates and allocates personal rights and duties between the contacting parties.[413] A contract takes legal effect when there are an offer, acceptance, consideration, and intention to create legal relations.[414] A transaction of a derivative is treated by private law as one of many types of contracts.

Among private law, particularly contract law and tort law have obvious relevance to disputes over 'mis-selling' of over-the-counter derivatives.[415] Contract law provides the framework for settling disputes over financial product transactions, with respect to formation, interpretation, and termination of contracts.[416] In particular, in many of the disputes of 'mis-selling' of over-the-counter derivatives, product performance are different from what consumers expected at the time of purchase; contract law provides the answer as to the validity of the contracts.[417] In disputes of 'mis-selling' of over-the-

[413] For example, defining in advance a profit and loss calculation method, the amount of money to be paid on a specific date, and others; see Timothy E Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 Loyola University Chicago Law Journal, 16 available at <http://lawecommons.luc.edu/luclj/vol43/iss1/3> accessed May 2016; Alaistar Hudson, *The Law of Finance (*2nd edition, Sweet & Maxwell 2013) 2-28; Simon James, *The Law of Derivatives (*Routledge, 2014) 20

[414] Simon James, (n 413) 175

[415] Alaistar Hudson, *THE LAW OF FINANCE* (n413) para 4.07-4.09

[416] Ibid

[417] Ibid 17-02

counter derivatives, there are also claims of wrongdoings including negligence and misrepresentation.[418] Tort law may be applied to provide compensation and other remedies when such wrongdoings are found.[419]

In the sphere of public law, financial regulation has been applicable to derivatives transactions. For example, in the UK, the Financial Services Act 1986 ("FSA 1986")[420] stipulates that no one could carry on 'regulated investment business' in the UK unless he is an 'authorized person' or an 'exempted person'.[421] Thereafter, transactions of derivatives where at least one counterparty is an 'authorized person'—that is, a financial institution—have been the subject of financial regulation.[422] The involvement of regulation has been further extended as EU legislation such as the Markets in Financial Instruments Directive ("MiFID") was implemented as statutory regulation in the public law sphere.

2.3.2 Legal risk of derivatives

Transacting an over-the-counter derivative exposes the parties to the transaction to new kinds of risks, including credit risk of the counterparty, market and liquidity risk of the transacted product, and legal risk.[423] Among these risks, credit risk, market risk, and liquidity risk are all economic risks.[424] Legal risk, in brief, is the risk that derivatives contracts are not enforceable.[425] Legal risks can come from several different sources.

The first source of legal risk is that a derivative contract can be void because of its nature. For instance, a derivative contract can be unlawful if it is seen as gambling or an

[418] Ibid 4-09
[419] Ibid
[420] See n471
[421] Financial Services Act 1986, s3; Schedule 1 s7-9 which defines its scope, and includes dealing in derivatives such as options and futures in 'regulated investment business.'
[422] FCA Handbook glossary where derivatives are a 'designated investment' and selling derivatives is a 'designated investment business'. Derivatives are a 'financial instrument' and 'dealing financial instruments on own account' or 'underwriting or placing financial instruments' are 'MiFID business', explaining selling derivatives is related business under FSMA 2000
[423] Simon James, *THE LAW OF DERIVATIVES* (Routledge, 2014) 15
[424] Ibid
[425] Ibid

unlicensed insurance.[426] An example case is *Morgan Grenfell v. Welwyn Hatfield District Council*[427], where the transacted interest rate swap was argued as a wagering transaction. The innovative characteristics of derivative contracts can easily create this risk.[428]

Second, the legal risk related to the counterparty can make the contract unenforceable.[429] Some counterparties may not have the legal ability to enter into a derivative contract by the constitution of the entities. Even when the counterparty has the legal capacity to enter into a derivative contract, the person purporting on behalf of the counterparty may not have the authority to represent the counterparty in the contract.[430] *Credit Suisse International v Stichting Vestia Groep*[431] is such a case. Another example of the legal risk arising from counterparties is the interest rate swaps brought to the court by the UK local authorities in 1990s.[432]

Third, the legal risk of over-the-counter derivative transactions can originate from actions during the pre-contractual stages, which may not be compliant with legal or regulatory requirements.[433] The claims of 'mis-selling' of over-the-counter derivatives are examples of the risk originating from this source. In private law, contract law and tort law provide the principles of permissible behaviours during the negotiating process.[434] Breach of these principles of private law may give the counterparty a right to rescind the contract or to obtain redress for their consequent loss.

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[426] Timothy E Lynch, (n 413) 47-49; Norman Menachem Feder, 'Deconstructing Over-the-Counter Derivatives' [2002*] Colum. Bus. L. Rev* 677, 728; see also George Walker, Robert Purves, and Michael Blair QC, *Financial Services Law* (OXFORD 2014) Para. 12.04

[427] [1995] 1 All ER1; see also *City Index v Leslie* [1992] 1 QB 98

[428] Norman Menachem Feder (n 426) 727

[429] Ibid 728

[430] Simon James (n 423) 16-17

[431] [2014] EWHC 3103; here, a public entity—a Dutch social housing association—contended that it lacked the constitutional capacity to enter into certain derivative contracts, and also that its managing director didn't have the authority to enter into them.

[432] *Hazell v Hammersmith & Fulham* [1992] 2 AC 1; Roger McCormick, *Legal risk in the financial markets* (Oxford University Press on Demand 2010) 205-218; Eddie Cade, *Law Relating to International Banking* (Routledge 1999) para 2.2.; the local authorities stated that contracting interest rate swaps was beyond the power entitled by the relevant statute to the local governments, and therefore void.

[433] Simon James (n 423) 17-18

[434] See n415

Statutory regulation also defines the mandatory duties of financial institutions in transacting over-the-counter derivatives.[435] Breach of these regulatory requirements can lead to various sanctions and an order of compensation for the loss of the consumer.

Conclusion

The chapter examined the over-the-counter derivatives markets in terms of 'mis-selling' disputes. The first ingredient of the over-the-counter derivative's vulnerability to 'mis-selling' is the asymmetry of information and knowledge between financial institutions and consumers, which results in high dependency on sellers by consumers. The fact that over-the-counter derivatives commonly are proprietary products that are designed by the seller explains why the imbalance of information and knowledge is severer in over-the-counter derivatives transactions.

Second, the substantial commission earned by financial institutions and generous financial incentives for salespersons contribute to a favourable environment for 'mis-selling'. Finally, the volatility of the financial markets and the high leverage of over-the-counter derivatives can result in severe financial damage to the consumer.

These three characteristics explain why the over-the-counter derivatives are more vulnerable to 'mis-selling', and address the first research question posed by this work.[436]

[435] See chapter III

[436] "What are the characteristics of over-the-counter derivatives which make them more vulnerable to "mis-selling" than other financial instruments?"

CHAPTER III. HOW TO DESIGN CONDUCT OF BUSINESS REGULATION

Introduction

A regulatory system contains two components: standard-setting and standard-enforcing. The chapter looks at the standard-setting of COB regimes. Using the comparative and evaluative methodology explained in section 1.3, the chapter identifies differences, explains the causes of the differences, and evaluates the effectiveness of different rulemaking approaches.

Section 1 explores the financial regulation in the two countries from a historical and constitutional context. To understand the history of how the COB has come to be formulated, the section looks at how the overall financial regulation has evolved and how COB is positioned within it. The section also analyses how the constitution can impact the boundary of rule-making.

Section 2 and 3 analyze the two countries' statutory rules for ameliorating the two key causes of 'mis-selling': information asymmetry and bounded rationality of consumers. These sections observe the different approaches of the two countries in rule-making as well as their different results.

Section 4 evaluates how effective the UK and South Korean rules are in achieving the regulatory objectives, which answers partly the third research question.[437] In addition, the institutional and cultural backgrounds that impact the rule-making approaches of the two countries are examined.

[437] "What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?"

3.1 The overall structure of financial regulation

In this section, the historical and constitutional background of financial regulation in the two countries is explained, which provides context necessary to understand how each has adopted its current approach to rulemaking.[438]

3.1.1 The overall structure of financial regulation in the UK

3.1.1.1 The evolution of financial regulation in the UK

In the twentieth century, there were three paradigm-shifting legislative changes in the financial services sector: the Prevention of Fraud (Investments) Act 1939/1958, the Financial Services Act 1986 ("FSA 1986"), and the Financial Services Market Act 2000 ("FSMA 2000"). George Walker and others explained the evolvement of regulation was an 'event-led process'[439] in which each of the enactments of the foregoing legislation gave impetus to transformation. This section will explore why this paradigm-shifting legislation was pursued and what changes were made to financial regulation in the UK.

The emergence of financial regulation

It was in the seventeenth century that stock brokers' dealings in bonds and shares first appeared.[440] Even then, records show that fraud and other false behaviours were prevalent in the market.[441] According to a report by the commissioners appointed by Parliament, it was said that the 'pernicious Art of Stock-Jobbing hath … so wholly perverted the End of Design of Companies'.[442] The report described various examples of promotional frauds, asset-stripping operations, insider dealing, and market manipulation.[443]

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[438] Robert A. Kagan, *Adversarial legalism: The American way of law* (Harvard University Press, 2009) location 107-206 (kindle edition)
[439] George Walker, Robert Purves, and Michael Blair QC, *Financial Services Law* (OXFORD 2014) Para 15.01
[440] Barry Rider, Charles Abrams, and Michael Ashe, *Guide to Financial Services Regulation* (CCH Editions, 1997) para102
[441] Ibid para103
[442] Ibid citing House of Commons Journals, 25 Nov 1696
[443] Ibid

In 1697, the 'Act to Restrain the Number and Ill Practice of Brokers and Stock-jobbers' was enacted.[444] This Act stipulated that stockbrokers and jobbers could deal in financial instruments only with a licence from the Lord Mayor and Court of Aldermen.[445] In the 1720s, many investors suffered losses from the 'South Sea Bubble'[446] and the 'Act to Prevent the Infamous Practice of Stock-Jobbing' was enacted to ban the dealing of all options and short selling in order to inhibit excessive speculation.[447]

Prevention of Fraud (Investments) Act 1939/1958

In the early 1930s, there were many reports of mis-leading advertisements of unit trusts.[448] There were also cases of fraud involving the sales of shares of worthless companies purely for margins.[449] However, the general law, which mainly used criminal punishments for fraudulent behaviours, revealed its limitations in dealing effectively with these sophisticated malpractices.[450] In response, the government enacted the Prevention of Fraud (Investments) ("PFI") Act 1939.[451] The PFI Act is considered the first modern statute to regulate investment services.

The PFI Act required a person to be licensed by the Department of Trade and Industry ("DTI") in order to deal in securities as a principal or an agent,[452] even though members of a self-regulatory organization were exempt.[453] This system tried to ensure that only fit and proper persons of good character and relevant expertise were allowed to deal in securities.[454]

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[444] Ibid para105
[445] Ibid; when obtaining the licence, the brokers and jobbers were required to take an oath to do business 'without fraud or collusion, to the best of my skill and knowledge'(ibid para 106)
[446] Havard Business School Baker Library, <http://www.library.hbs.edu/hc/ssb/history.html.> accessed 1 Mar 2015
[447] Barry Rider, Charles Abrams, and Michael Ashe (n440) para106
[448] Modern Law Review, 'Reports of committees: Interdepartmental Committee on Sharepushing (Cmd. 5539)' (1938) 313
[449] Ibid 68
[450] Barry Rider, Charles Abrams, and Michael Ashe (n440) para110
[451] It was later re-enacted as the PFI 1958 Act.
[452] Prevention of Fraud (Investment) Act 1958, s 1 (1) (a), (b) (PFI Act 1958)
[453] PFI Act 1958, s 15
[454] George Walker, Robert Purves, and Michael Blair QC (n439) Para. 15.09

The PFI Act also prohibited making a misleading statement to induce consumers to invest in securities.[455] This provision was the first explicit statutory provision to prevent the fraudulent inducement of investment.[456] Under the PFI Act, the DTI created a conduct of business rules for licensed persons.[457] This rule required, among others obligations, a licensed person to provide a prospectus containing certain information on the securities offered.[458] The conduct of business rule at the time was basically disclosure-based regulation.

Financial Services Act 1986

By the early 1980s, the shortcomings of the PFI Act were becoming apparent. The regulatory scope of the PFI Act excluded the members of a self-regulatory organization.[459] The Act also provided exemption for financial institutions which dealt in securities as their ancillary business.[460] Over time, many financial institutions could establish that dealing in securities was ancillary to their main business; thus, they obtained exemption.[461] As a result, the number of exempted firms increased so that exemption came 'to be regarded as a prized status symbol'.[462]

In addition, the scope of the PFI Act only covered licensed dealers and not investment advisors.[463] In terms of product coverage, it didn't include sophisticated investment products such as options.[464] Such a narrow scope of financial products which the Act covered was another apparent shortcoming.

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[455] PFI Act 1958, s 13
[456] George Walker, Robert Purves, and Michael Blair QC (n439) para 15.12
[457] PFI Act 1958, s 7
[458] Graham F. PIMLOTT, 'Reform of Investor Protection in the UK--An Examination of the Proposals of the Gower Report and the UK Government's White Paper of January' (1985) 7 *Journal of Comparative Business and Capital Market Law* 141, 143, citing 1939 Rules, 1939 STAT. R.&O. 2757, Part I, Rule 2
[459] PFI Act 1958, s 15
[460] PFI Act 1958, s 16 (1) (a) (i)
[461] Graham F. PIMLOTT (n458) 145
[462] L.C.B. Gower, 'Review of Investor Protection: A Discussion Document' (HM Stationery Office 1982) 14-15
[463] George Walker, Robert Purves, and Michael Blair QC (n 439) para 15.13
[464] See n353; Henry TC Hu, 'Hedging Expectations: Derivative Reality and the Law and Finance of the Corporate Objective' (n353) 1011; Todd E. Petzel, 'Derivatives: Market and Regulatory Dynamics' (1995) *21 J. Corp. L.* 95, 98; see also George Walker, Robert Purves, and Michael Blair QC (n 439) para. 15.12

Further, the regulatory system under the PFI Act was also difficult to enforce. The enforcement of statutory regulation relied on criminal punishment, which demanded a high standard of proof and so had a low rate of success.[465] Self-regulatory organizations ("SROs") could use only non-legal sanctions such as adverse publicity, which were not perceived to be strong enough to create discipline in the market.[466]

In 1981, scandals such as Norton Warburg[467] occurred which highlighted the need for a comprehensive review of investor protection under the PFI Act. These scandals raised questions about whether the PFI Act provided proper protection to investors.[468]

The FSA 1986 was the first legislation in the UK to formulate a comprehensive regulatory framework for the financial investment industry.[469] Most of the important concepts for investor protection were developed by this Act. The FSA 1986 created a 'practitioner-based, statute-backed' regulatory regime, which consisted of the Securities and Investments Board Ltd. ("SIB") and certain recognized SROs.[470] Compared with the PFI Act, the scope of the new regime had a wider coverage of investment instruments and businesses, including transacting in derivatives.[471]

The legislation enhanced the enforcement power of the SIB.[472] The SIB was given the power to ban individuals guilty of misconduct from being employed by financial institutions[473] and to apply to the court for restitution orders to compensate consumers against financial institutions which contravened the rules made by the SIB or SROs.[474]

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[465] Graham F. PIMLOTT (n458) 148
[466] Ibid
[467] Norton Warburg became insolvent with a deficit of £ 2.5 million. It had invested clients' money in companies of its own group, which went into default and caused many clients to suffer huge losses; see Graham F. PIMLOTT (n458) 146; another scandal shocked the City when a fund manager of a merchant bank was suspected of obtaining improper benefits from a stockbroker; see David Kynaston, *The City of London* (CHATTO & WINDUS LONDON, 2002) 595
[468] David Kynaston, *The City of London* (CHATTO & WINDUS LONDON, 2002) 595
[469] George Walker, Robert Purves, and Michael Blair QC, (n439) 15.21
[470] Financial Services Act 1986 (hereafter, "FSA 1986"), s 59
[471] FSA 1986, s 1; FSA 1986, Schedule 1 s7-9
[472] FSA1986, ch 5
[473] FSA1986, s 59
[474] FSA 1986, s 61

The Act also afforded civil remedies to investors who suffered losses as a result of contravention of rules by financial institutions.[475]

Financial Services and Markets Act 2000

The FSMA 2000 was introduced when the FSA 1986 became ineffective. Because boundaries between different financial services blurred in the 1990s, the FSA 1986, which regulated different financial services separately through sector-focused SROs, revealed its ineffectiveness.[476] For example, one financial institution with various businesses in different financial services was regulated by different SROs.[477] This system created regulatory arbitrariness across different financial services.[478] With these reasons, the newly elected government in 1997 declared the reform of the financial regulatory regime as one of its commitments.[479]

The first priority of the new financial services legislation was to create a single statutory regulator charged with supervising and regulating the entire range of financial services.[480] The biggest change by the FSMA 2000 was the advent of the FSA which took over the responsibilities and roles of the existing nine regulators.[481] The most important powers given to the FSA were to create rules and sanction when the rules were breached. Under the FSMA 2000, the FSA could make statutory rules in response to market developments and make different levels of rules from principles to detailed regulations. The FSMA 2000 also ensured that the FSA had sufficient disciplinary power to use against wrongdoers.[482] The FSA could take actions to prevent problems caused by regulated firms from

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[475] FSA1986, s 62

[476] HM Treasury, *Financial Services and Markets Bill: A Consultation Document part one* (1998) 1

[477] George Walker, Robert Purves, and Michael Blair QC, (n439) 15.30

[478] Deborah A. Sabalot, *Butterworths New Law Guides: The Financial Services and Markets Act 2000* (LexisNexis 2004) 1.26; see also Joint Committee of the Lords and Commons on Financial Services and Markets, *First Report* (1999) para 99, where it described the rationale of the new legislation as "The existing arrangements for financial regulation involve a large number of regulators…In recent years there has been a blurring of the distinction between different kinds of financial services."

[479] Deborah A Sabalot (n478) 1.27

[480] George Walker, Robert Purves, and Michael Blair QC (n439) 15.31

[481] Nine regulators were the Securities Investment Board, Personal Investment Authority, Investment Management Regulatory Organization, Securities and Futures Authority, the former Supervision and Surveillance Division of Bank of England, the Building Societies Commission, Insurance Directorate, the Friendly Society Commission, the Registrar of Friendly Societies

[482] FSMA 2000, s 66, s 206, s 206A, s 384 and s 55J

spreading.[483] Moreover, the FSA could impose direct sanctions on all authorized firms which failed to comply with the regulatory rules.[484]

The Financial Services Act 2010 and the Financial Services Act 2012

The enactment of the Financial Services Act 2010 ("(FSA 2010") and the Financial Services Act 2012 ("FSA 2012") was the statutory response to the 'failures' of the regulation to prevent the global financial crisis. The area on which the FSA 2010 mostly focused was the maintenance of financial stability following the costly lessons learned from the crisis. The FSA 2010 also tried to improve financial consumers' overall protection.

One of the methods introduced to enhance consumer protection was the 'consumer redress scheme'.[485] Under this scheme, the regulator can make regulatory rules which require relevant financial institutions to establish a consumer redress scheme under which they should provide redress to consumers who have suffered losses from the failure of compliance with statutory duties.[486]

The consumer redress scheme differs from other redress tools [487] in that this scheme is intended to be used for widespread consumer detriments. A restitution order has rarely been used because this action should be taken on a case-by-case basis; thus, it isn't useful for a regulator with limited resources.[488] The FOS, another regulatory redress scheme, was also not designed for dealing with large-scale consumer detriments but for dealing with individual cases. The private law has been incapable of responding to generic claims because of the complicated processes for group litigation and inconsistent rulings by different courts.[489]

The consumer redress scheme was adopted for collective regulatory redress for large-scale consumer detriments. However, the consumer detriments which the scheme can

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[483] Ibid
[484] Ibid
[485] FSMA 2000, s 404
[486] Joanna Gray, 'The Legislative Basic of Systemic Review and Compensation for the 'mis-selling' of Retail Financial Services and Products' (2004) 25 (3) *Statute Law Review* 196, 204-206
[487] FSMA 2000, s 384; this significant power had originally been allowed only to the Treasury to authorize the regulator to establish the scheme.
[488] Great Britain H. M. Treasury, *Reforming financial markets* (The Stationery Office, CM 7667, 2009) 113
[489] Ibid 114

address are limited to those for which it would seem that the courts would order remedies.[490] Considering the difficulty of proving causality in the courts between regulatory breaches and the detriments, the requisite of judicial remedy seeming to be available hinders the regulator in exploiting the scheme.[491]

The FSA 2012 overhauled the regulatory system and created the FCA which focuses on the conduct of financial institutions' business.[492] The FSA 2012 moved away from unified supervision towards a bifurcated twin-peaks structure, with the formation of a conduct of business regulator (the FCA) and the micro-prudential regulator (the Prudential Regulatory Authority). The twin-peaks[493] regulatory model is based on the belief that the prior financial regulatory system had failed to cope effectively with the global financial crisis which commenced in 2007.[494]

However, many stakeholders were also unsatisfied with the predecessor's role as a conduct regulator. The comment by the House of Commons in the appointment report for the chairman of the FCA exemplified this dissatisfaction.[495]

While the financial stability agenda was the key in the regulatory reform after the global crisis, the consumer protection agenda has also been one of the areas given attention. There are two reasons. First, the global financial crisis and the following recession

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[490] Financial Services Authority, 'Guidance note No.10 Consumer Redress Schemes' *(*2010) para 7.4; see n982

[491] Financial Services Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) 8 <www.fsa.gov.uk/pubs/other/pls.pdf> accessed 6th October 2017; see chapter IV 4.5; As such, there has been only one use of the scheme by the regulator in 2012; see Financial Services Authority, 'FSA announces redress scheme for Arch cru investors' (2012) <http://www.fsa.gov.uk/library/communication/pr/2012/114.stml> accessed 20 May 2015

[492] Great Britain H. M. Treasury, *A new approach to financial regulation: the blueprint for reform* (The Stationery Office, CM 8083, 2011) 15

[493] David T Llewellyn, 'Institutional structure of financial regulation and supervision: the basic issues' (6th and 7th June. 2006*)* World Bank seminar Aligning Supervisory Structures with Country Needs, 27-28

[494] Great Britain H. M. Treasury, *A new approach to financial regulation: the blueprint for reform* (n492) 8; HM Treasury said that the most significant regulatory failing during the crisis was poor and non-responsible supervision for the entire financial system;

[495] House of Commons Treasury Committee*, Appointment of John Griffith-Jones as Chair-designate of Financial Conduct Authority* (The Stationery Office, 2013) 3, where it said that "He [the first chairman of FCA] must restore the credibility of the conduct regulator. The FCA is the successor to a body which failed consumers. Although it devoted a great deal of time and effort to conduct matters, it left consumers exposed to some of the worst scandals in UK financial history."

illustrated the connectedness of consumer protection with financial stability.[496] Excessive mortgages which were loaned to many sub-prime borrowers who couldn't afford the loans were securitized and spread to the wholesale market.[497] As the defaults of sub-prime mortgagees increased, the securitized products suffered severe losses which resulted in the crisis of the global financial system.[498] The failures to protect consumers in the retail and wholesale markets can be said to have caused the systemic turbulence.[499]

Second, the momentum of strengthening policy for consumer protection was triggered by the crisis in public confidence in the financial industry. The global financial crisis made consumers lose confidence in financial institutions. Dried-up liquidity and the squeezed profitability of financial institutions drove them to turn their backs on consumers' needs. Financial institutions, under the pressure of liquidity during the crisis, tightly reduced their lending to individuals and SMEs when consumers really needed funding.[500] In particular, the publicly funded bailout for failed financial institutions enraged the public.[501] The organized angry voice of the public put political pressure on policymakers to enhance consumer protection.[502]

3.1.1.2 Current financial regulation of the UK

FSMA 2000 amended

The FSMA 2000 amended by the FSA 2010, the FSA 2012, and other primary legislation[503] are the current statutes regulating financial markets, including over-the-

[496] Erik F Gerding, 'Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk' (2009) 5 *FIU L. Rev.* 93, 95-98
[497] Ibid
[498] Ibid
[499] Ibid
[500] Great Britain H. M. Treasury, *Reforming financial markets* (n 488) 44
[501] Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' in Ferran E et al, *The regulatory aftermath of the global financial crisis* (Cambridge University Press, 2012) Location 5055-5080 (kindle edition); Public anger pushed people to voluntarily organize movements such as 'Occupy Wall Street' and 'Occupy London'
[502] Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' in Ferran E et al, *The regulatory aftermath of the global financial crisis* (Cambridge University Press, 2012) Location 5055-5080
[503] The Bank of England Act 1998 and Banking Act 2009

counter derivatives. FSMA 2000 amended established the basic framework of the UK's financial regulation. It created regulators and defined 'regulated activities'[504].

If FSMA 2000 amended created the 'skeleton' of financial regulation, it is the regulator that adds the 'muscles' to the skeleton.[505] Blair explained that if FSMA 2000 set out specific regulatory requirements, excessive cost and time would be required to adapt the Act to minor changes in the market; thus, the regulatory system would be inflexible.[506] FSMA 2000 amended provided for flexibility and responsive capability in the regulatory system by providing the regulator with wide discretionary power.[507] In addition, FSMA 2000 didn't include conduct of business and prudential rules for authorized firms; instead, it delegated such rule-making to the regulators.[508] Thus, the framework of the UK's regulatory system consists of the regulatory framework created by the FSMA 2000 and the detailed regulatory requirements set out by the regulators.[509]

FCA Handbook

FSMA 2000 conferred a broad rule-making power to the regulator. The rules created under this power are collected in the *FCA Handbook* and *PRA Handbook*. Most of the key regulatory requirements of COB are contained in the *COBS* of the *FCA Handbook*.

FSMA 2000 allowed the regulator to make two different types of rules which have different legal effects: 'Rule' and 'Guidance'. Rules which apply to financial institutions' conduct of 'regulated activities' set out detailed requirements which are enforceable.[510] A contravention of a Rule generally doesn't constitute a criminal offence but will result in

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[504] FSMA 2000 Part 2

[505] Charles Abrams, *Short Guide to the Financial Services Markets Act 2000* (Sweet & Maxwell, 2000) 5

[506] Michael Blair, George Walker, and Robert Purves (eds), *Financial services law* (Oxford University Press, 2009) para 1.16

[507] Jonathan Middleburgh, 'The Financial Services and Markets Bill: A legal perspective' (1998) 6.4 *Journal of Financial Regulation and Compliance* 379, 379

[508] Ibid 3-6; 1.16; Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) 8; Jonathan Middleburgh, 'The Financial Services and Markets Bill: A legal perspective' [1998] 6.4 *Journal of Financial Regulation and Compliance* 379

[509] Eilis Ferran and Chales A.E. Goodhart, 'Regulating Financial Services and Markets in the 21st Century: An Overview' in Eilis Ferran and Chales A E Goodhart, *Regulating Financial Services and Markets in the 21st Century (*Hart Publishing, 2001) 1; Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) 61-65; the regulatory system under FSMA 2000 is 'rule-based' rather than 'statute-based'.

[510] FSMA 2000, s 137A (1)

disciplinary actions.[511] Moreover, a private right of action is provided to a private person who has incurred a loss.[512]

Guidance provides information and advice about regulatory requirements to the regulated.[513] Guidance doesn't have a formal legal status; however, in practical terms, its legal effect isn't insignificant. When a regulatee complies with Guidance, the FCA recognizes the regulatee as having complied with the related Rule.[514] In contrast, failure to comply with the Guidance doesn't necessarily mean that there is a breach of the related Rule.[515] There are various ways to comply with a Rule: Guidance is just one of these. The regulatee is supposed to identify the optimal way of complying with a Rule.[516] However, Guidance is potentially relevant to an enforcement case because enforcers can take the Guidance into account when considering the matter.[517] The regulator isn't prohibited from taking disciplinary action because there is no breach of Guidance. Without a breach of Guidance, the regulator can decide that there is a breach of a Rule.[518] In sum, Guidance can be a 'weapon of defence' but cannot be a 'weapon of attack'.

Another rule type which should be explained is the Principles in the *FCA Handbook*.[519] Strictly speaking, Principles are Rules made by the regulator under the rule-making power. However, they differ in form and legal status compared with other Rules. A Principle represents a general statement of the fundamental obligations of financial institutions.[520] Principles describe an outcome required but not the method of how such

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[511] Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) 226

[512] FSMA 2000 s138D

[513] FSMA 2000 s139A; Guidance can be divided into general guidance, which applies to all regulatees, and individual guidance, which applies to specific regulatees. General guidance is contained in the *FCA Handbook*, but individual guidance isn't publicized.

[514] FCA Handbook DEPP 6.2.1G (4); FCA, *Readers Guide: an introduction to the Handbook (2013) 24*

[515] FCA Handbook EG 2.9

[516] Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (Oxford University Press, 2009) 232-234

[517] FCA Handbook EG 2.9.4

[518] FCA Handbook EG 2.9.6

[519] FCA Handbook High Level Standards

[520] Joanna Gray and Jenny Hamilton, *Implementing financial regulation: Theory and practice* (John Wiley & Sons, 2006) 61; Ruth Fox and Ben Kingsley, A Practitioner's Guide to the UK Financial Services Rulebooks (Thomson Reuters, 2013) 54

the outcome should be achieved.[521] For example, a Principle can stipulate a behavioural outcome that an authorized firm must 'act with integrity'. However, it doesn't explain how to 'act with integrity'.[522] Thus, in determining whether a regulatee has complied with a Principle, the enforcer's discretion cannot but have more weight compared with Rules.[523]

Because a Principle is a high-level standard, it can be applied to an identical situation simultaneously with a Rule.[524] Thus, when the regulator analyses a case, they apply a combination of the related Rule and Principle to it.[525] By doing this, the Principle can provide a boundary of application for the more detailed Rule.[526] Alternatively, when there is no Rule to apply, the Principle can be applied. In *R (British Bankers Association) v Financial Services Authority & Anor*, the court ruled that a Rule is a particular requirement derived from a Principle and that Rules cannot be an exhaustive list of Principles.[527]

A contravention of a Principle is subject to the regulator's disciplinary action. However, the breach of a Principle doesn't provide a private right of action while the breach of a Rule is an actionable at the suit for a private person.[528]

Other published materials

The FCA treats other materials and industry guidance similarly to the Guidance in the *FCA Handbook*.[529] In other words, when the regulator's other published materials or industry guidance have been complied with, the regulator will not take disciplinary action.[530] Industry guidance is information made by a body other than the regulator to guide compliance with the *FCA Handbook* in relation to a particular financial industry. As

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[521] Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) 223
[522] FCA Handbook PRIN 2.1R
[523] Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) 223
[524] Ibid 225
[525] Ibid
[526] Ibid
[527] [2011] EWHC 999 (Admin) [162]
[528] FSMA 2000 s138D (3);
[529] See n514
[530] FCA Handbook EG 2.9.4G; the FCA makes this clear in the 'Decision Procedure and Penalties Manual' in its Handbook.

long as it satisfies the conditions and processes[531] as stipulated by the FCA, the regulator recognizes it as appropriate industry guidance.[532] Confirmed industry guidance also has the same effect as Guidance in the *FCA Handbook*.

3.1.1.3 Constitutional constraints of rule-making in the UK

The rule of law

In the UK, a country without a written constitution, the concept of the rule of law has changed with the times. Dicey defined 'rule of law' as the 'absolute supremacy of predominance of regular law as opposed to the influence of arbitrary power' and wrote that '[e]nglishmen are ruled by the law and *by the law alone*'.[533] He contrasted the rule of law to a system based on officials with arbitrary power. Scholars including Dicey who have embraced the rigid rule of law have claimed that discretionary decision-making destroys the rule of law.[534] However, later scholars have argued that it isn't only impossible to apply such a rigid rule of law in reality but that it is also undesirable.[535] Davis stated that it was impossible to identify all the major questions related to policies in advance and to reflect the answers in law.[536]

After such debate, today in the UK, the meaning of the rule of law is understood as a principle which requires that executive action must be based on law. When a conflict exists about an executive action, the court must decide whether the law's requirements

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[531] FSA, 'FSA confirmation of Industry Guidance: Feedback on DP06/5' (2007) available <http://www.fsa.gov.uk/pubs/policy/ps07_16.pdf > annex 1, accessed 30th December 2016

[532] Ibid

[533] Albert Venn Dicey and Emlyn Capel Stewart Wade, *Introduction to the Study of the Law of the Constitution* (London: Macmillan, 2011, 8th edition) Location 4531 (Kindle edition)

[534] Ibid

[535] Paul P. Craig, *Public law and democracy in the United Kingdom and the United States of America* (Oxford University Press, 1990) ch 2; Jeffrey Jowell, 'The rule of law today' in Jeffrey Jowell and Dawn Oliver, *The changing constitution* (Oxford University Press, 2007) 23; Anthony Wilfred Bradley and Keith D. Ewing (n860) 79-81

[536] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) *38 where he provided* four fundamental reasons; first, legislators only have the ability to suggest the broad framework for policymaking; second, policy decisions are likely to be made based on knowledge of a narrow scope of circumstances; thus, such policies are vulnerable in other circumstances; third, legislators are not well equipped to mediate controversy between conflicting interest groups; thus, they rely on the courts or the government for this function; fourth, even if a policy is appropriate for legislative determination, there can be cases where a clear decision isn't made because of disagreement between legislators.

have been complied with.[537] If executive action is deemed by the courts to be beyond legal powers, this action is declared *ultra vires*.[538] The modern meaning of the rule of law recognizes the role of the discretion of administrative officials in executive action, but requires that the method or scope of the executive action must be within the boundary of the law, which is the *principle of legality*.[539]

The rule of law is understood in terms of its close connection to the values of certainty and predictability.[540] This is because the rule of law stipulates that government intervention should be controlled by rules; thus, by understanding the rules, individuals should be able to expect with certainty how the government will use its coercive power and can plan accordingly.[541] In other words, an individual should be able to know the legal consequences from his behaviour.[542]

Legislative supremacy

Briefly defined, legislative supremacy means that there is no limitation to the legislative power of Parliament.[543] It can also be understood as the *sovereignty of Parliament*.[544] This doctrine, which gives supremacy to the legislation, limits the role of the courts to only applying the legislation and doesn't give them the authority to decide whether the legislation is constitutional.[545] Such inability of the courts in the UK to perform a judicial review of the legislation is a characteristic of a country with an unwritten constitution.[546]

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[537] Anthony Wilfred Bradley and Keith D. Ewing (n860) 81-84

[538] Ibid

[539] Ibid

[540] Ibid 87

[541] Bruce Caldwell, *Hayek's The Road to Serfdom: A Brief Introduction* (University of Chicago Press, 2013) location 697 (kindle edition)

[542] *Black-Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg* AG [1975] AC 591, 637-639

[543] Albert Venn Dicey and Emlyn Capel Stewart Wade, *Introduction to the Study of the Law of the Constitution* (n533) Location 2611-2745 (kindle edition)

[544] Anthony Wilfred Bradley and Keith D. Ewing (n860) 48; see also Albert Venn Dicey and Emlyn Capel Stewart Wade, *Introduction to the Study of the Law of the Constitution* (n533) Location 2297 (kindle edition), where they described legislative supremacy as 'no person or body is recognized by the law of England as having a right to override…the legislation of Parliament'.

[545] Anthony Wilfred Bradley and Keith D. Ewing (n860) 49-51

[546] Ibid 51; in countries with a written constitution, such as other common law countries including the United States, if the legislation doesn't comply with the constitution, the courts can rule it as invalid. In the UK, legislation only becomes invalid when Parliament enacts new overriding legislation.

The *supremacy of Parliament* is also recognized in the process of delegating Parliament's legislative power to secondary legislation. In the UK, there is no constitutional constraint on the delegation of legislation to secondary legislation.[547] This is in contrast to the United States, which has a non-delegation doctrine.[548] The non-delegation doctrine requires that when parliament delegates law-making to secondary legislation it must provide standards that guide the exercise of the delegated power.[549] However, in the UK, Parliament can delegate such power in extremely wide discretionary terms.[550] Consistently, FSMA 2000 provides a broad rule-making power to the FCA without any specified constraints.[551]

3.1.2 The overall structure of financial regulation in South Korea

3.1.2.1 The evolvement of financial regulation in South Korea

South Korea's financial regulatory system underwent a significant transformation after the 1997 Asian financial crisis. During the years from 1948, when the Korean government was established, to 1997, the Treasury of the government had overarching regulatory power over the financial industry, including banking, investment and insurance.[552] Regarding the investment and insurance industries, the Treasury exercised indirect regulatory power through separate executive regulatory bodies.[553] The Bank of Korea's Monetary Policy and Operation Committee regulated the banking industry. However,

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[547] Paul Craig, 'Regulation and Judicial Review: Perspectives in the UK and EC Law' in Christopher McCrudden, *Regulation and Deregulation (*Clarendon Press, 1999) 123; see also Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications (*Oxford University Press, 2010) 249

[548] D.J. Galligan, *Discretionary Powers: A Legal Study of Official Discretion (*Clarenden Press, 2011) 208-209

[549] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) *44-45*

[550] D.J. Galligan, *Discretionary Powers: A Legal Study of Official Discretion (*Clarenden Press, 2011) 208-209

[551] FSMA 2000 s137A (1); see n507; however, see Paul Craig, *Administrative Law (*Sweet & Maxwell, 2016, 8th edition) Location 19106-19594 (kindle edition), where the author explained that UK pursues accountancy and transparency in delegated rule-making through other methods such as consultation, publication, the scrutiny of Parliament, and judicial reviews.

[552] Hong-Bum Kim, 'What Have We Learned from the Financial Regulatory and Supervisory Experiences for the Last Ten Years since the 1997 Financial Crisis?' (2007) 21 *Korean Journal of Money and Finance*, 55, 56

[553] The Securities Supervisory Board and the Insurance Supervisory Board

because the Treasury Minister was the chairman of the committee, the Treasury maintained regulatory power over this industry.[554]

The concentration of all policy means in the Treasury without adequate checks and balances was recognized as a problem within the government after the 1997 crisis.[555] As a result, the financial regulatory function of the Treasury was transferred to a nine-member committee named the Financial Supervisory Committee, with an executive regulatory body, the Financial Supervisory Service ("FSS"). [556] The FSS became the integrated sole regulator of the overall financial industry, obtaining regulatory power from prior regulatory bodies.[557]

The development of South Korea's financial regulatory legislation was undertaken by means of a top-down approach. This approach is rooted in the history of the financial industry, which began as an industry fostered by the government for policy reasons.[558] The main reason that the Korean government first enacted the Securities and Exchanges Act in 1962 was to provide capital needed by the manufacturing sector.[559] COB was also developed by the government rather than driven by self-regulation because of the increase in individual investors in the financial market and the need for legislation to provide investor protection.[560]

South Korea's financial regulatory legislation is founded on an 'industry separation' policy.[561] Banking, investment, and insurance each had its own legislation; moreover, the legislations had different requirements for entrance, business conduct, and prudentialilty. [562] The Banking Act regulated banks and the Insurance Act regulated insurance companies. The regulation of the financial investment industry was based on

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[554] Ibid n2
[555] Ibid 57
[556] *Act on the Establishment, etc of Financial Supervisory Organizations* Article 4 and Article 17
[557] *Act on the Establishment, etc of Financial Supervisory Organizations* Article 37
[558] Chan-Hyung Chung, 'The History and Contents of Korean Financial Law' [2012] 9.1 *The Korean Journal of Financial Law*, 157
[559] Chan-Hyung Chung, 'The History of Korean Financial Industry' [2014] 2014.2 *KIF Financial Report,* 1, 121
[560] Chan-Hyung Chung, 'The History and Contents of Korean Financial Law' (n558) 167-170
[561] Goo Bonsung, *The Integration of Financial Services Law in Korea: Key Issues* (Korea Institution of Finance, 2005) 4
[562] Ibid

multiple legislations.[563] Each piece of legislations regulated the applicable financial institution such as security companies, futures companies, asset management companies, and real estate investment companies.[564] Further, each Act in the financial investment industry had its own entrance, business conduct, and prudential regulation.[565] In 2009, the Acts were integrated into the Financial Investment Services and Capital Markets ("FISCM") Act. As a result, the Banking Act, the Insurance Act, and the FISCM Act currently regulate the financial industry.

The FISCM Act broadly defines financial investment instruments as instruments with the risk of loss of principal, of which the objective is to earn a profit or avoid a loss.[566] The FISCM Act then defines the businesses which deal in financial investment instruments as 'financial investment businesses' and classifies them into six types[567]. Under the FISCM Act, each business has slightly different regulatory requirements regarding entrance, business conduct, and prudential regulation.[568]

The regulatory significance of the FISCM Act was that it introduced 'function-based regulation'.[569] Function-based regulation is based on the economic function or risk of business conducted by an investment company. This approach differs from the 'institution-based regulation' which characterized the regulation before the FISCM Act. Thus, at least in the financial investment industry, the FISCM Act transformed the institution-based regulatory framework into one which was function-based. The function-based regulation of the FISCM Act applied to all financial instruments which meet the definition of a 'financial investment instrument' regardless of the industry. Consequently, if a financial investment instrument is handled by a bank or an insurance company, the

[563] The Securities and Exchange Act, the Futures Trading Act, the Indirect Investment Asset Management Business Act, and the Real Estate Investment Company Act

[564] Those Acts are 'Securities and Exchange Act', 'Futures Trading Act', 'Indirect Investment Asset Management Business Act', 'Real Estate Investment Company Act', 'Ship Investment Company Act' etc. See Ministry of Finance and Economy, 'Explanation Material on FISCM Act Bill' (2006) 13

[565] Ministry of Finance and Economy, 'Explanation Material on FISCM Act Bill' (n563) 13-16

[566] FISCM Act Article 3 (1)

[567] Trading, brokerage, collective investment, advisory, discretionary investment, and trust businesses

[568] FISCM Act Article 6

[569] Sunsup Jung, '금융규제법 차원에서 본 자본시장법 [FISCM Act from the Perspective of Financial Regulatory Law]' [2013] 61 *BFL*, 6

FISCM Act would be applied to the transactions alongside the Banking Act and the Insurance Act.[570]

3.1.2.2 Current financial regulation in South Korea

The FISCM Act has secondary legislation: the 'Presidential Decree' and 'Ordinance of the Prime Minister'. However, a substantial part of the regulatory requirements is stipulated in the primary legislation, the FISCM Act. The secondary legislation only describes peripheral or procedural details when these are specifically delegated by the FISCM Act.[571] 'Specifically delegated' means that the primary legislation clearly identifies what is delegated; in addition, the secondary legislation clearly states what has been delegated from the primary legislation. The following example presents the 'know your client' obligation stipulated in Article 46 (2) of the FISCM Act. The procedural details, which are delegated from the Act, are described in Article 52 of the Presidential Decree. Secondary legislation doesn't include any new regulatory requirement not stipulated in the FISCM Act.[572]

<example>

FISCM Act Article 46 (2):	**Presidential Decree Article 52:**
Each financial investment business entity shall obtain information about the investment purpose, status of property, experience in investment, etc. of an ordinary investor through interviews, inquiries, etc. before recommending him/her to make an investment, and shall require the ordinary investor to make a signature, print his/her name and affix his/her seal, record conversations, or have a confirmation in any other manner specified by Presidential Decree, and keep and maintain the confirmation safely, and shall furnish the investor with the confirmed information without delay.	"Manner specified by Presidential Decree" in Article 46 (2) of the Act means any of the following manners: 1. Electronic mail or any other similar electronic means of communication; 2. Mail; 3. Automatic telephone answering system *(Underlines are added by the author.)*

[570] Ibid 10
[571] See ch 3.2.2.3
[572] See p 9 7

In addition, the regulatory legislation in South Korea doesn't have a rule type such as the Guidance in the UK because most of the rules in the legislation are mandatory.[573] Instead, to clarify regulatory requirements, all regulatory rules are required to be written clearly and plainly by the constitution.[574]

3.1.2.3 Constitutional constraints of rule-making in South Korea

South Korea's constitution explicitly or implicitly describes the formal requirements for legislation.[575] The formal requirements are the 'principle of pre-formulation of state actions by legislation' and the 'principle of clarity'.[576] These formal requirements restrict the method of making rules in the primary and secondary legislation.

Pre-formulation of state actions by legislation

'The principle of pre-formulation of state actions by legislation' means that administrative actions must be based on primary legislation.[577] This principle emphasizes that because the primary legislation is enacted by the National Assembly, administrative actions must not only be based on the National Assembly's decisions; such decisions must also be the result of the enactment of legislation.[578] The constitution of South Korea proclaims this principle through its articles, stating that restrictions on the fundamental rights of the people must be based on primary legislation[579] and that the National Assembly alone has legislative power[580]. This principle expresses the comprehensive obligation of the administration regarding legislation.[581]

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[573] See Frederick Schauer, *Playing by the Rules*: *A Philosophical Examination on Rule-Based Decision Making In Law and in Life* (n111) location 2997-3009 (kindle edition)

[574] See n594

[575] Ministry of Government Legislation, '법령입안심사기준 [Examination Criteria of Primary and Secondary Legislation]' 24-48 available at http://www.moleg.go.kr/knowledge/policyResearch?searchYear=&searchCondition=All&searchKeyword=%EB%B2%95%EB%A0%B9%EC%9E%85%EC%95%88%EC%8B%AC%EC%82%AC%EA%B8%B0%EC%A4%80&x=20&y=14 accessed 10th September 2017

[576] Ibid 33-39

[577] Constitutional Research Institute, '법률유보와 의회유보 [Pre-formulation of state actions by legislation]', 5 available at https://ri.ccourt.go.kr/cckri/cri/study/selectPublishList.do accessed 10th September 2017

[578] Ibid

[579] Constitution of Republic of Korea, Article 37 (2)

[580] Constitution of Republic of Korea, Article 40; in the case of Constitutional Court of Korea, 1995.11.30, *91Hunba;* the Constitutional Court ruled that 'policy-making related to important aspects of the constitutional

Another principle which must be understood in connection with the 'principle of pre-formulation of state actions by legislation' is the 'the principle of bans on inclusive delegated legislation'. The 'principle of bans on inclusive delegated legislation', which means that restrictions on people's fundamental rights must be based on legislation and cannot be inclusively delegated to the administration, can be deduced from the principle of pre-formulation of state actions by legislation.[582] Article 75 of the Constitution states that the President, as the head of administration, has the power to create Presidential Decrees 'concerning matters delegated to him by the Act with the scope *specifically defined*'.[583] The Constitutional Court interpreted this provision as prohibiting inclusive delegated legislation.[584] The Constitutional Court explained that the 'ban on inclusive delegated legislation' is a requirement about the 'clarity'[585] of legislation delegated to administrators and that the delegation of legislation must be sufficiently defined and limited in its range, objective, and scope to enable the public to predict administrative action to a certain degree.[586]

Whether a matter relates 'to important or essential aspects of the constitutional fundamental rights and obligations of the people'[587], in which case the parliament cannot delegate legislative power, is determined by the Constitutional Court on a case by case

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fundamental rights and obligations of the people must be done by the legislature consisting of representatives elected by the sovereign, the people, through the form of primary legislation.' The Constitutional Court refers to 'popular sovereignty', the 'separation of powers', and the 'rule of law' as the rationale for this ruling. 'The principle of pre-formulation of state actions by legislation' expresses the comprehensive obligation of the administration regarding legislation.

[581] Matthias Koetter, and Gunnar Folke Schuppert, 'Rechtsstaat und Rechtsstaatlichkeit in Germany' (n870)

[582] Nam Chul Chung, '명확성원칙의 판단기준과 사법심사의 한계 [Entscheidungsmaßstab des Bestimmtheitsgebots und Grenzen der gerichtlichen Kontrolle]', (2008) 57.9 *법조* [*Judges and Lawyers*] 1, 6

[583] Constitution of The Republic of Korea Article 75

[584] Kim Byung Hwah, '위임입법의 통제에 관한 연구 [A study on the control over the legislative delegation]' (1999) Seoul National University PhD Thesis 144 available at <http://www.nl.go.kr/nl/search/SearchDetail.nl?category_code=ct&service=KOLIS&vdkvgwkey=895453&colltype=DAN_DMDP&place_code_info=000&place_name_info=%EB%B3%B4%EC%A1%B4%EC%9A%A9%EC%9E%90%EB%A3%8C&manage_code=MA&shape_code=B&srchFlag=Y&lic_yn=N&mat_code=DP&recomno=> accessed 10th September 2017

[585] See n594

[586] Constitutional Court of Korea, 2003.07.24, *2002 Hunba 82*, Korean Constitutional Court Report (hereafter "KCCR") 15-2, 131,141.

[587] See n580

basis.[588] The Constitutional Court states that *predictability*, the *purpose of legislation*, and the *object of regulation* are the criteria for determining legitimacy of delegation in legislation.[589]

'Predictability' requires that the primary legislation must have sufficient detail to enable the public and the court to draw an outline of what should be stipulated in the delegated legislation.[590] In other words, despite how clear and specific the delegated secondary legislation is, the primary legislation itself should provide enough information to predict what the secondary legislation should specify.

The 'purpose of legislation' requires that 'predictability should be considered not only for the particular delegation provision but the entire legislation wholly'.[591] According to the Constitutional Court, even when the specific scope of delegation isn't clearly defined, if the scope of the delegation can be objectively determined based on the purpose and overall frame of the legislation, then there is no contravention of the 'principle of a ban on inclusive delegation'.[592]

The 'object of regulation' provides that the extent of specificity and clarity necessary for delegation varies in accordance with the subject on which the delegated legislation is regulating. Regarding legislation which may directly restrict basic human rights, such as criminal provisions, the criteria of specificity and clarity to be applied should be significant; however, if the legislation is a beneficial provision or one where the object of regulation is diverse or frequently changes, the criteria can be softened.[593]

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[588] Hong Seok-Han, 'A Study on the Constitutional Limitations of the Delegated Legislation - analysis and evaluation of the constitutional court's criteria for constitutionality of delegated legislation' (2010) 11 *Public Law Journal* 215, 222

[589] Ibid 222-226

[590] Constitutional Court of Korea, 1995, *91Hunba1*, KCCR, 562,591; Constitutional Court of Korea, 1999.01.28, *97 Hunga 8*, KCCR 11, 1,8

[591] Constitutional Court of Korea, 2004.11.25, *2003 Hunba 104*, *KCCR 16-2*, 355, 368; Constitutional Court of Korea, 2004.02.26, *2001 Hunba 75*, *KCCR 16-1*, 184, 194 ~ 195.

[592] Ibid

[593] Constitutional Court of Korea, 1994.07.29, *92 Hunba 49*, KCCR 6-2, 64, 101; Constitutional Court of Korea 2003.11.27,*2003 Hunba 2*, KCCR 15-2, 281, 291 ~ 292; Constitutional Court of Korea 2009.07.30, *2007 Hunba 15*, Public notification 154, 1459, 1464; Constitutional Court of Korea, 2009.03.26, *2008 Hunba 105*, KCCR 21-1, 457,461; Constitutional Court of Korea, 2009.03.26, *2008 Hunba 105*, *KCCR* 21-1, 457,461; Constitutional Court

The principle of clarity

The 'principle of clarity' means that legislation which restricts people's fundamental rights must be clearly written to enable a normal person with sound common sense to understand, in advance of taking action, what action is prohibited and what is allowed.[594] The principle requires that those subject to legislation be able to understand it in advance, thereby providing them with a standard for future behaviour and strengthening legal stability and predictability.[595] By this principle, the enforcer will be provided with an objective guide for decision-making, preventing arbitrary execution.[596] The principle of clarity isn't explicitly stated in the Constitution; however, the Constitutional Court has ruled that it is derived not only from the rule of law doctrine but also the protection of fundamental human rights.[597]

Whether a provision of legislation is clear or not varies depending on who is making the judgement. The Constitutional Court has explained that the principle of clarity doesn't mean that any person should be able to clearly understand the meaning; instead, it is sufficient if an 'average person in society' can understand the meaning. Moreover, with regard to legislation which only applies to people with certain occupations, the principle

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of Korea, 2009.06.25, *2007 Hunba 39*, 1261,1264; Constitutional Court of Korea 2009.10.29, *2007 Hunba 63*, 1915,1915; particularly for 1) provisions where the object of regulation is very diverse and can change frequently requiring flexible responses to economic and social changes, 2) provisions related to a specialized or technical area where there are many changes based on development in modern scientific technology and society, and 3) provisions related to formulating detailed procedures, the court ruled that it is more effective to regulate these flexibly through administrative legislation.

[594] Constitutional Court of Korea, 1996. 8. 29, *94 Hunba15*; Constitutional Court of Korea, 1996. 12. 26, *93 Hunba 65*; Constitutional Court of Korea, 1998. 4. 30, *95 Hunga 16*, *KCCR* 10-1, 327, 341; Constitutional Court of Korea, 2002. 1. 31, *2000 Hunga 8*, *KCCR* 14-1, 1, 8; Constitutional Court of Korea, 2008. 4. 24, *2004 Hunba 92*, 528, 531; Constitutional Court of Korea, 2010. 4. 29. *2008 Hunba 118*, *KCCR* 22-1, 676, 682

[595] Constitutional Court of Korea, 2008. 1. 17, *2007 Hunma 700*, KCCR 20-1, 139, 164; Constitutional Court of Korea, 2011. 8. 30, *2009 Hunba 128*, *KCCR* 23-2, 304, 320; Constitutional Court of Korea, 2012. 8. 23, *2010 Hunba 28*, *KCCR* 24-2, 420, 428

[596] Constitutional Court of Korea, 2010. 10. 28, *2008 Hunma 638*, KCCR 22-2, 216, 228; Constitutional Court of Korea, 2012. 2. 23, *2009 Hunba 34*, KCCR 24-1, 80, 87-88

[597] Constitution of Republic of Korea Article 37 (2) 'The freedoms and rights of citizens may be restricted by Act only when necessary for national security, the maintenance of law and order or for public welfare. Even when such restriction is imposed, no essential aspect of the freedom or right shall be violated.'; Constitutional Court of Korea, 1992. 4. 28, *90Hunba27*, *KCCR* 4, 255, 268-269
327, 341-342; Constitutional Court of Korea, 2000. 2. 24, *98 Hunba 37*, *KCCR* 12-1, 169, 179; Constitutional Court of Korea, 2001. 6. 28, *99 Hunba 34*, *KCCR* 13-1, 1255, 1264

means that the 'average person' from that population can understand it.[598] In addition, considering that a legislative provision cannot help but use generic and abstract language, if the provision can be understood by a judge with her complementary interpretation, and if no possibility exists that the interpretation will vary depending on the personal disposition of the interpreter, then the Constitutional Court has ruled that the provision cannot be deemed to be in breach of the principle of clarity.[599]

Another ruling stated that when a provision of legislation includes generic or abstract language, its clarity depends on whether a reasonable interpretation can be made based on consideration of the legislation's purpose and interrelationship with the legislation's other provisions or the provisions of another legislation.[600] The Constitutional Court has also ruled that a provision which has more burdensome consequences will require a higher standard of clarity compared with beneficial provisions. Further, those related to criminal law or where interests are in sharp conflict are prohibited from using vague language, and if vague language cannot be avoided, detailed definitions must be provided to eliminate the possibility of arbitrary interpretation.[601]

To summarize the Constitutional Court's position on the principle of clarity, legislation must be made so that those subject to it can clearly understand its meaning; however, the clarity required isn't unconditional or maximal but should enable an 'average' regulatee to understand the meaning. This position recognizes the inevitability of using generic/abstract concepts in legislation and that the level of clarity required can vary

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[598] Constitutional Court of Korea, 2012. 2. 23, *2009 Hunba 34*, *KCCR* 24-1, 80, 88; for the 'average consumer test' of the EU, see Rossella Incardona and Cristina Poncibo, 'The average consumer, the unfair commercial practices directive, and the cognitive revolution' (n404) 21-26

[599] Constitutional Court of Korea, 1998. 4. 30, *95 Hunga 16*, *KCCR* 10-1, 327, 341-342; Constitutional Court of Korea, 2001. 6. 28, *99 Hunba 31*, *KCCR* 13-1, 1233, 1239; Constitutional Court of Korea, 2005. 12. 22, *2004 Hunba 45*, *KCCR* 17-2, 712, 721; Constitutional Court of Korea, 2008. 1. 17, *2007 Hunma700*, *KCCR* 20-1, 139, 164; Constitutional Court of Korea, 2010. 4. 29, *2009 Hunba 46*, *KCCR* 22-1, 21, 27; Constitutional Court of Korea, 2011. 8. 30, *2009 Hunba 128*, KCCR 23-2, 304, 320; Constitutional Court of Korea, 2012. 8. 23, *2010 Hunba 28*, *KCCR*, 420, 428; Constitutional Court of Korea, 2012. 12. 27, *2011 Hunba 225*, *KCCR* 24-2, 467, 473

[600] Boo-Ha Lee, '법적 안정성의 의미에서 명확성 원칙[Die Forderung nach Klarheit und Bestimmtheit im Sinne von Rechtssicherheit]', (2013) 20.1 *World Constitutional Law Review*, 1, 9-10

[601] Constitutional Court of Korea, 1992. 2. 25, *89 Hunga 104*; Constitutional Court of Korea, 2001. 6. 28, *99 Hunba 34*; Constitutional Court of Korea, 2002. 7. 18, *2000 Hunba 57*; Constitutional Court of Korea, 2002. 1. 31, *2000 Hunga 8*

depending on the type, objective, and object of the legislation. In other words, the clarity requirement of the Constitutional Court is 'minimum clarity', not 'maximum clarity'.[602]

Two cases on which the Constitutional Court has ruled in relation to the principles of 'pre-formulation of state actions by legislation' and 'clarity' help to understand these principles. The first case concerned the Securities and Exchanges Act (the SE Act), Article 54.[603] This Act provided the Financial Services Commission with the authority to 'issue necessary orders to security companies'. The case was also related to Article 209[604] of the Act, which stipulated that a contravention of the orders issued based on Article 54 is punishable by imprisonment. The Constitutional Court ruled that Article 209 is a breach of the 'principle of a ban on inclusive delegated legislation' and 'clarity'. [605]

A contrasting case concerns Article 21 of the Act on the Establishment and Operation of the Korean Communications Commission. Article 21 states that as one of its responsibilities, the Korean Communications Commission can 'deliberate and request for correction on information prescribed by the Presidential Decree as necessary to nurture sound communication ethics'. The phrase of 'sound communication ethics' was ruled as constitutional by the Constitutional Court.[606]

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[602] Constitutional Court of Korea, 2011. 8. 30, *2009 Hunba128* , KCCR 23-2, 304, 320

[603] SE Act Article 54: 'The Financial Services Commission may issue necessary orders to securities companies in order to prevent excessively speculative transactions and to protect the public interest and investors.'

[604] SE Act Article 209: 'A person who falls under any of the following subparagraphs shall be punished by imprisonment for not more than two years or by a fine not exceeding ten million won… 7. A person who violates the order based on the orders by Article 54'

[605] Constitutional Court of Korea, 2004.9.23, *2002 Hunga*, 26, where it stated that "The delegation of provisions causing criminal punishment must be detailed enough so that the activity subject to punishment can be estimated and the type, limit and extent of punishment must be clearly stipulated. However, the provision only stated that necessary orders can be issued 'as stipulated in the Presidential Decree', inclusively delegating the specifics about the orders to secondary legislation. The SE Act, Article 54 doesn't enable an estimate to be made about the details of what can be subject to punishment. Further, it doesn't specify any restrictions or a broad outline of what is to be stipulated in the Presidential Decree, thereby resulting in a blind delegation. This can lead to arbitrary legislating, which also breaches the principle of legality."

[606] Constitutional Court of Korea, 2011Hun-Ga13, where it stated that "The concept of 'sound communication ethics' is rather abstract but… considering the wide scope and rapid speed of change in the information communication sector, as such a vague expression can be seen as inevitable, it cannot be said that the provision in question is in contravention of the 'principle of clarity".

The above two cases show that for legal requirements related to criminal punishment, the principles of a 'ban on inclusive delegation' and 'clarity' are strictly applied; however, there can be flexible application depending on the legislation's object.

Ironically, the administration of South Korea has a more rigid position compared with the Constitutional Court about the principles of a 'ban on inclusive delegation' and 'clarity'. From the administration's perspective, it is important to minimize any possibility of the legislation which it has drafted and enforced to be later ruled as unconstitutional. The high standards that the administration applies can be seen, for example, in the 'Examination Criteria for Promulgated Legislation'. These criteria were developed by the Ministry of Government Legislation, which performs pre-screening of the legislation drafted by each department before it is sent to the parliament for ratification.[607] The criteria emphasize that executive agencies should not be given discretionary power more than is necessary and sets out specific standards.[608] The criteria also state that when the use of 'indeterminate language' is inevitable, the legislation must be written in language which is clear and plain to enable the enforcer or regulatees to accurately understand the meaning. [609]

The Presidential Committee on Government Innovation and Decentralization ("PCGID"), which was created for the purpose of making 'transparent and effective government' in 2004, announced five objectives, one of which was 'to encourage maximum transparency in government decision-making.[610] Regarding this objective, the PCGID recommended all ministries to rephrase their primary and secondary legislation to ensure that it is as clear as possible.[611]

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[607] Ministry of Government Legislation (n575) 33-41

[608] For instance, inaccurate concepts such as 'sufficient human resources and facilities' and 'financial soundness' should be expressed in quantifiable terms such as 'measures regarding a facility', 'the number of employees', and 'the amount of capital'; see Ministry of Government Legislation (n575) 35

[609] Ministry of Government Legislation (n575) 35

[610] Jongcheol Kim, 'Government Reform, Judicialization, and the Development of Public Law in the Republic of Korea' in Tom Ginsburg and Albert HY Chen (eds), *Administrative law and governance in Asia: comparative perspectives* (Routledge, 2008) location 2629-2654

[611] Ibid

The tight criteria in rule-making can also be seen in conduct of business rules, which will be explained in the following sections. In sum, compared with the judicial position of adopting a 'minimal clarity' approach with flexibility based on the type of legislation, the administration's position is seen to pursue 'maximum clarity'.[612] The principles of 'pre-formulation of state actions by legislation' and 'clarity' required by the Constitution affect rule-making in the financial regulation as well.

3.2 The regulation of information asymmetry

The section 3.1 examined the overall structure of financial regulation in the UK and South Korea, which is the groundwork for a better understanding of COB in the two countries. The following investigates how COB which addresses informational asymmetry between financial institutions and consumers is formulated in the two countries.

3.2.1 The rationale for regulatory intervention

In most commercial transactions, each party isn't legally obliged to disclose all necessary information about the transacted goods to the counterparty.[613] In general, *'caveat emptor'* is a common law principle applied to ordinary commercial transactions which enhances the efficiency of these transactions by encouraging the production of information in society.[614] However, in the financial market there are two theoretical rationales for mandatory disclosure.

The first rationale is price accuracy. The accurate price of financial instruments supports the fairness of transactions and the efficiency of the entire economy. Because most financial instruments are credence goods, the quality of which cannot be evaluated even after purchase and consumption,[615] and because the service provider has little incentive to provide information about financial products, which have characteristics of public

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[612] Ministry of Government Legislation (n575) 35

[613] Paul G. Mahoney, 'Mandatory disclosure as a solution to agency problems' (1995) 62.3 *University of Chicago Law Review* 1047, 1047

[614] Richard A. Posner, *Economic Analysis of Law* (6th edition, Aspen Law and Business, 1998) 111; see also Colin Bamford, *Principles of international financial law* (Oxford University Press, 2011) 221

[615] Peter D. Spencer, *The structure and regulation of financial markets* (OUP Oxford, 2000) Location 125 (kindle edition)

goods,[616] mandatory disclosure helps the market identify an accurate price. Akerlof showed that with asymmetric information between market participants, adverse selection may hinder a market's establishment or lead to a low-quality market.[617] Mandatory disclosure can provide necessary information for investors for their investment decisions and can thereby help the market to function well.[618]

Price accuracy in the financial market is also important for allocative efficiency in the economy. The financial market acts as a resource allocative mechanism in an economy; thus, if the price of a financial product is inaccurate, resource allocation in the entire economy becomes inefficient. The resource allocative function of financial instruments shows that tighter disclosure regulation for financial instruments is needed than for other products.[619]

The second rationale is the agency cost. Mahoney contended that agency problems between capital raisers and investors in securities markets were the main targets of a mandatory disclosure system.[620] This rationale isn't only confined to the primary market, where issuers of securities raise funds from investors, but also extends to the secondary market for transactions of securities and other investment products, including over-the-counter derivatives.[621]

Regarding transactions of investment products, when undertaking the transactions, consumers need 'multidimensional' information about the products and the related market.[622] For example, when entering into an interest rate hedge contract, the consumer needs to consider the various conditions such as the product type, maturity, and right of early exit. This decision requires consumers to synthetize and take account

[616] John C. Coffee, 'Market failure and the economic case for a mandatory disclosure system (1984) Vol. 70, No. 4 *Virginia Law Review*, Fifty Years of Federal Securities Regulation: Symposium on Contemporary Problems in Securities Regulation, 717, 722-724

[617] George A. Akerlof, '"The market for "lemons": Quality uncertainty and the market mechanism' *The quarterly journal of economics* [1970] 488

[618] John C. Coffee, 'Market failure and the economic case for a mandatory disclosure system (n616) 717

[619] Ibid

[620] Paul G. Mahoney, 'Mandatory disclosure as a solution to agency problems' (n613)

[621] Mads Andenas and Iris HY Chiu, *The foundations and future of financial regulation: Governance for responsibility* (Routledge, 2013) 23

[622] David Llewellyn, *The economic rationale for financial regulation* (n7) 24

of their financial situation, the product's features, and expected market movements.[623] In sum, the decision about whether to execute a financial transaction, especially a complex transaction, requires a substantial level of expertise, knowledge, and the ability to integrate many different kinds of information.

Obtaining necessary information isn't impossible but costly.[624] The search process for information costs consumers a great deal of time and effort. For instance, consumers may find it difficult to quote contract conditions for currency over-the-counter derivatives from a bank without a prior relationship.[625] The high search cost may make customers stop looking for information on alternative providers.[626] Thus, consumers are likely to depend for necessary information on a financial institution when transacting financial products.[627] In addition, a consumer's dependency on a financial institution imposes a high cost when the consumer changes her provider because she has to abandon the cost which has been invested to build a relationship with the current provider.[628]

The increasing complexity of financial instruments can impair the effectiveness of disclosure requirements.[629] It may not be sufficient just to require all information about financial products to be disclosed. Oral or written explanations by representatives of financial institutions are the main source of information for product features.[630] Consumers' expectations about market movements can be heavily influenced by the

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[623] See n1324

[624] Kristine Erta et al., *Applying behavioural economics at the Financial Conduct Authority* (FCA, 2013) 24 available at < http://oro.open.ac.uk/42192/1/occasional-paper-1.pdf> accessed 13th September 2017

[625] See p 7 1

[626] A survey on retail consumers in the EU member states showed that only 33% of investors compared their investment products with other providers' products or different products of the same provider; see Nick Chater et al., 'Consumer Decision-Making in Retail Investment Services: A Behavioral Economic Perspective' (2010) 7 Report to the European Commission/SANCO, available at <http://ec.europa.eu/consumers/financial_services/reference_studies_documents/docs/consumer_decision-making_in_retail_investment_services_-_final_report_en.pdf> accessed 6th October 2017

[627] Christine Cuccia, 'Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives' (1997) 22 *Del. J. Corp. L.* 197, 200-201

[628] European Capital Markets Institute and Centre for European Policy Studies, *MiFID 20: Casting New Light on Europe's Capital Markets (2011)* p124; Great Britain H. M. Treasury, *Reforming financial markets* (The Stationery Office, CM 7667, 2009) para 9.5

[629] Steven L. Schwarcz, 'Regulating Complexity in Financial Markets' (2009) 87 *Wash. U. L. Rev.* 211, 220-230

[630] See n1324

opinions of sales representatives.[631] In transactions of over-the-counter derivatives, even large corporate clients substantially rely on a financial institution's explanation of a product's features because over-the-counter derivatives are designed by the financial institution. [632] Information asymmetry and the consumer's reliance on a financial institution for necessary information serve as practical barriers for consumers to find the best products to satisfy their needs.

Communication between financial institutions and consumers at the pre-contractual stage is the main source from which consumers obtain information about the financial product. Particularly in transactions of over-the-counter derivatives, consumers cannot help but rely on the explanations about the products' features and risks given by financial institutions, the manufacturers of the products.[633] In fact, among civil cases of the 'mis-selling' of over-the-counter derivatives, many are related to claims of consumers being misled by communication with financial institutions. [634] Thus, regulatory requirements apply to financial institutions' communications with their consumers.

3.2.2 Regulatory rules for information asymmetry in the UK

COBS stipulates regulatory requirements for solving informational asymmetry in financial product transactions, as follows: ways to communicate[635] and the information which should be provided to consumers[636].

COBS chapter 4 applies to communication with a client and financial promotion to the general public.[637] *COBS* especially sees financial promotion as a key source of consumer detriment and thus takes significant care over it.[638] Among the requirements in *COBS*

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[631] See eg *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518

[632] Christine Cuccia (n627) 200-201; see also *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518; Colin Bamford, *Principles of international financial law* (Oxford University Press, 2011) 221

[633] See p 2

[634] See Table 1 at p 163 and Table2 at p 188

[635] FCA Handbook, COBS Chapter 4

[636] FCA Handbook, COBS Chapter 6

[637] Ruth Fox and Ben Kingsley, *A Practitioner's Guide to the UK Financial Services Rulebooks (*Thomson Reuters, 2013) 231-232

[638] Simon Morris, *Financial Services Regulation in Practice* (Oxford University Press, 2016) location 14915 (kindle edition)

chapter 4, 'the fair, clear and not misleading communication rule' (hereafter "fair communication rule") provides the base requirement.[639] This Rule stipulates that 'a firm must ensure that a communication is fair, clear and not misleading'.[640] It requires a financial institution to provide not only factually right information but also 'fair' information. Fair communication means that a financial institution should provide suitable information to a client and a balanced view of the investment.[641] Fairness can be said to require fiduciary obligation because the financial institution should determine what information is suitable and balanced from the perspective of the best interest of the client.[642]

The 'fair communication rule' with its purposive and vague vocabulary such as 'fair', 'clear', and 'not misleading' is complemented by four specific Guidances.[643] These Guidances explain that the 'fair communication rule' applies to all categories of clients, but in a proportionate way. This means that the method and content of a communication can differ in accordance with different client groups, depending on their knowledge and experience;[644] that financial institutions should make clear in their financial promotions the product's risk in terms of clients' capital;[645] and that the use by financial institutions of misleading words in their promotions such as 'guaranteed', 'protected', and 'secure' can be deemed as breaches of the 'fair communication rule'.[646] Moreover, financial institutions should provide sufficient information about charges when charging structures are complex.[647]

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[639] FCA Handbook, COBS, 4.2.1 (1)R
[640] Ibid
[641] Alaistar Hudson, *THE LAW OF FINANCE* (n413) 10-19
[642] Ibid
[643] FCA Handbook, COBS, 4.2.2G - 4.2.5G
[644] FCA Handbook, COBS, 4.2.2 (1)G
[645] FCA Handbook, COBS, 4.2.4 (1)G
[646] FCA Handbook, COBS, 4.2.5G
[647] FCA Handbook, COBS, 4.2.2 (3)G; the 'fair communication rule' is supplemented by more detailed Guidances for communication with retail clients. These Guidances require that any information which is given should 1) avoid emphasizing a product's benefit without giving a fair indication of any relevant risk; 2) be sufficient for the average recipient to understand; 3) not disguise, diminish, or obscure important items, statements, or warnings; 4) present comparative information in a balanced way and disclose sources and assumptions; 5) state that any information about tax depends on individual circumstances; and 6) be consistent with any information which the financial institution provides; FCA Handbook, COBS 4.5

Interestingly, *COBS* includes a Rule to confine the civil liability of financial institutions from a breach of the 'fair communication rule'. It stipulates that if a financial institution takes reasonable steps to comply with the 'fair communication rule', the firm doesn't assume civil liability from the right of action entitled by section 138D of the FSMA 2000.[648] This means that the 'fair communication rule' is an absolute requirement which demands financial institutions ensure that their consumers understand all the necessary factors of the transacted products. If financial institutions show that they have taken reasonable steps to comply with this absolute rule, they can be exempted from civil liability but not regulatory sanctions.[649]

This Rule can be seen as a statutory attempt to enhance the stability and predictability of the 'fair communication rule' by excluding the courts, which are not part of the financial industry community and so may not share the common norms of the community, from the task of interpreting the vague 'fair communication rule'.[650]

COBS also specifies what information should be given to consumers before providing services, in addition to how to communicate.[651]

3.2.3 Regulatory rules for information asymmetry in South Korea

Unlike the 'fair communication rule' of the *COBS* in the UK, the FISCM Act of South Korea doesn't stipulate the overall obligations related to communication between financial institutions and clients; instead, it provides regulations on the method and contents of only investment recommendations and advertisements.

Communication with retail clients; The Guidance about charges is especially important for transactions of over-the-counter derivatives because the commission is usually included in the bid-and-ask price[647]

[648] FCA Handbook, COBS, 4.2.6R

[649] Field Fisher Waterhouse, 'A Guide to the New Conduct of Business Sourcebook and new Systems and Controls rules' (2007) 19-20 available at <http://wwwfieldfishercom/pdf/NEWCOB-and-SYSCpdf> accessed 6th October 2017

[650] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997)

[651] *COBS* 2.2.1 contains a high level Rule for a financial institution to provide appropriate information about 1) the financial institution and its services; 2) proposed investments and strategies and warning of associated risks; 3) execution venues; and 4) cost and associated charges. *COBS* 4.6 has specific and detailed requirements in using past and future performance in communication and financial promotion in relation with retail clients. COBS has additional requirements on a 'direct offer financial promotion' which is a financial promotion that contains an offer to enter into an agreement, for example a brochure accompanied by an application form. COBS has made prohibition rules for a cold call and non-written financial promotions.

The regulation of investment recommendation consists of the 'duty to explain', which applies only to ordinary investors, and the 'prohibition on undue recommendation', which applies to all investors. The 'duty to explain' places three obligations on financial institutions when they recommend investment products. First, it requires that financial institutions should explain to an 'ordinary investor' the details of the product, the risks contingent on the investment, the product's structure and characteristics, the fees for the transaction, and the terms and conditions of the cancellation of contracts. These explanations must be given in a way that an 'ordinary investor' can understand.[652] Second, financial institutions should obtain from an ordinary investor a confirmation with her signature stating that she has understood the details explained by the financial institution.[653] Third, financial institutions should not provide false or distorted information while explaining material facts and should not omit an explanation of any material facts.[654]

The FISCM Act imposes a civil liability on a financial institution which has breached the 'duty to explain'. Moreover, it reduces the burden of proof on a consumer by stipulating that the entire loss which she has suffered from the recommended investment is presumed to be the amount of loss caused by the breach of the 'duty to explain' by the financial institution.[655] In accordance with this right of action and reduced burden of proof, a consumer has only to prove, in court, a breach of the 'duty to explain' by a financial institution.[656]

Loophole in the scope of the 'duty to explain'

One noteworthy aspect about the 'duty to explain' in the FISCM Act is that the duty is applied only when financial institutions *recommend* investment products to *'ordinary investors'*. In other words, the cases where an 'ordinary investor' transacts an investment product without a financial institution's recommendation or where a 'professional

[652] FISCM Act 47 (1); FISCM Act Presidential Decree 53 (1)
[653] FISCM Act 47 (2)
[654] FISCM Act 47 (3)
[655] FISCM Act 48
[656] A consumer doesn't need to prove causation between the breach and her loss.

investor' transacts with or without a recommendation are excluded from the remit of the 'duty to explain'.

As a result, under the FISCM Act, financial institutions don't have any specific duties to communicate with clients except when recommending products to 'ordinary investors'. Because of the asymmetry of information between financial institutions and consumers, including large corporate clients, it is probable that financial institutions can influence consumers' decisions by delivering only favourable facts in order to sell a product without disclosing false facts.[657] This is why regulation of fair communication with all client categories is necessary.

This regulatory 'loophole'[658] was recognized by the South Korean regulator, the Financial Supervisor Service ("FSS"), one year after the enactment of the FISCM Act. Consequently, the FSS revised the *Standard Working Rules on Investment Recommendation*,[659] which is an example created by an SRO about the internal controls which are required when financial investment instruments are recommended. This revision recommended to explain about a product's major risks when transacting with 'ordinary investors' without recommendations.[660] However, there is still no regulatory requirement about the type of communication required from financial institutions when they conduct transactions with 'professional investors'.

Proxy rule of 'duty to explain'

[657] Peter D. Spencer, *The structure and regulation of financial markets* (n615) Location 125 (kindle edition)

[658] Sunsup Jung, '금융상품 분쟁해결의 법리 [Legal Theory of Settling Disputes of Financial Instruments' (2013) 58 *BFL* 6, 14-15, where he suggested that 'duty to explain' exempt to the recommendation to 'professional investor' should be expanded to the 'professional investor' but he didn't comment about the necessity of 'duty to explain' in communication without recommendation.

[659] Financial Supervisory Service, 'Revision of Standard Working Guidance of Investment Recommendation' (2010) 13, available at <http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=14499&no=1&s_title=투자자 보호의 실효성 제고를 위한 투자권유제도 선&s_kind=title&page=1> accessed 4th October 2016; see n677 for detailed explanation

[660] Financial Supervisory Service, 'Revision of Standard Working Guidance of Investment Recommendation' (n659) 13

The second aspect to note about the FISCM Act's 'duty to explain' is the requirement of financial institutions to obtain a consumer's signed confirmation that she has understood the details explained in the recommendation.[661] Interestingly, any rules which require a written confirmation of understanding cannot be found in the *COBS* of the UK. The rulebook prior to the *COBS*, demanded that financial institutions take reasonable steps to ensure a consumer's understanding.[662] The *COBS* went further, requiring that financial institutions *must* communicate in a 'fair, clear, and not misleading way' and not just take reasonable steps to ensure consumers' understanding.[663] However, if a financial institution takes reasonable steps to comply with the 'fair communication rule', the contravention of the rule doesn't give rise to a right of action although it can be sanctioned by the UK regulator.[664]

The requirement to obtain a consumer's confirmation of understanding about the explanation is a 'proxy' which enables the regulator to monitor compliance to the 'duty to explain'. It is time- and effort- consuming for the regulator to check whether consumers understand a financial institution's explanation. In terms of compliance costs, it is also burdensome for the regulated to ensure that each consumer understands what was explained without a simple tick-box.[665] Black commented that when the monitoring of compliance is difficult in practical terms, a proxy for monitoring compliance is adopted.[666] However, she stressed that adopting a proxy doesn't usually have a positive effect on achieving regulatory goals; indeed, it may counteract such an achievement.[667]

As Black expected, the requirement to confirm a consumer's understanding of an explanation seems to counteract achieving the purpose of the 'duty to explain'. Such counter-effect can be twofold. First, the requirement to obtain the confirmation may

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[661] See n653
[662] COB 5.4.3R
[663] COBS 4.2.1 (1)R
[664] COBS 4.2.6R; see n649
[665] See Ministry of Strategy and Finance, *Opinions from stakeholders about FISCM Act* (2006) 55 <http://www.mosf.go.kr/lw/lap/detailTbPrvntcView.do?menuNo=7040000&searchNttId1=OLD_1001029&searchBbsId1=MOSFBBS_000000000055> accessed 3rd October 2016
[666] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997)223
[667] Ibid; see also Stephen G. Breyer, *Regulation and its Reform* (n909) location 1625-1652 (kindle edition) where he used the term of 'design standard'.

cause the 'duty to explain' to be just a 'tick-box rule', thereby resulting in the regulated missing the spirit of the rule.[668] The regulatory goal of the 'duty to explain' is to ensure that consumers understand the major characteristics of a recommended product. Thus, the 'duty to explain' should lead the regulated to develop their own reasonable steps to ensure consumers' robust understanding. However, with this proxy rule, a high probability exists that the regulated focus on obtaining the confirmation and not on ensuring consumers' understanding.[669] Indeed, the South Korean regulator found that after the FISCM Act was enacted, financial institutions' sales representatives showed a tendency to give explanations to consumers in a monotonous and perfunctory way and simply wished to receive the signatures confirming understanding.[670]

The second aspect of the counter-effect related to the proxy rule concerns enforcement. The requirement to receive confirmation is easy for sales representatives to comply with. It is highly likely that consumers will confirm their understanding of explanations without seriously thinking about whether or not they understand them. This means that, in the case of financial institutions' failure to comply with the 'duty to explain', the regulator, in public enforcement, and an aggrieved consumer, in private enforcement by litigation, should deny the validity of a signed confirmation. However, it isn't easy for the regulator and a consumer to deny the efficacy of a signed confirmation which is stipulated by law.[671]

Prohibition of undue recommendation

The FISCM Act has a clause about the prohibition of an undue recommendation which is separate from the 'duty to explain'. This clause, unlike the 'duty to explain', also applies to professional investors and defines five undue recommendations[672] With regard to

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[668] Julia Black, 'The rise, fall and fate of principles based regulation' (n820) 13-15

[669] Sunsup Jung, '금융상품 분쟁해결의 법리 [Legal Theory of Settling Disputes of Financial Instruments' (n659) 36

[670] Financial Supervisory Service, *Revision of Standard Working Guidance of Investment Recommendation* (n659) 12

[671] Juhn Wook, 'The Investor Protection Measures under The Capital Market and Financial Investment Services Act' (2008) *The Justice* 107, 193, 216-217

[672] FISCM Act Article 49; the five undue recommendcations are : 1) providing false information, 2) providing a decisive judgement on an uncertain matter or information which is likely to mislead, thereby causing an

financial institutions' communication with clients, except for investment recommendations, the FISCM Act doesn't have other regulation.

Regulation of advertisements

The FISCM Act stipulates detailed obligations for advertisements which solicit investments.[673] The regulation of advertisements which solicit investments is a good example of the characteristics of the delegated rule-making process in South Korea. This process isn't the way in which the primary legislation stipulates overall obligations and the subordinate legislation supports it with greater detail. Instead, the primary legislation stipulates the detailed obligations and through the subordinate legislation, additional obligations of similar levels of precision are added. This characteristic is a result of strictly complying with the 'principles of pre-formulation of state actions by legislation'[674], 'bans on inclusive delegated legislation',[675] and 'clarity'.

The Working Rules on Investment Recommendation

The provision of the 'Working Rules on Investment Recommendation' (WRIR) is one of the new aspects of the FISCM Act. The provision of the WRIR represents a variant of meta-regulation [676] which combines self-regulation and statutory regulation. The

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uncertain matter to be believed to be certain, 3) cold calling, 4) repeating an investment recommendation after an investor has manifested an intention to reject it, and 5) recommending an investment under the condition that a loan will be granted without being asked for such a service by an ordinary investor who doesn't have such experience of investment with credit.

[673] FISCM Act Presidential Decree Article 60; the Act requires that 1) the name of the financial institution and the contents and risk of the financial investment instruments must be included and 2) an advertisement must not include any expression which can cause a misunderstanding that compensation for losses is provided and that returns are guaranteed, and which confers all other matters to Presidential Decree. The Presidential Decree requires that an advertisement which solicits investments should 1) include a statement that a financial institution has a duty to provide a full explanation of financial investment instruments and to recommend making an investment only after hearing the explanation; 2) include details of the fee; 3) refrain from showing the return of the investment or management results only for the period of time during which the investment had good performance results; 4) refrain from representing, without solid grounds, that other financial investment instruments are inferior or disadvantageous; and 5) obtain confirmation from the compliance officer in advance.

[674] See n577

[675] See n582

[676] Joanna Gray and Jenny Hamilton, *Implementing financial regulation: Theory and practice* (John Wiley & Sons, 2006) 227-263; see also Christine Parker, 'Meta-Regulation: Legal Accountability for Corporate Social Responsibility?' in Doreen McBarnet, *The New Corporate Accountability: Corporate Social Responsibility and the Law* (Cambridge University Press, 2009) 207-240; see also Cary Coglianese and Evan Mendelson, 'Meta-

provision states that 1) '[a] financial investment business entity shall establish specific guidelines and procedures which its executive officers or employees shall comply with in making investment recommendations'; 2) 'a financial investment business entity shall announce its established working rules on investment recommendations to the public through its Internet home page'; 3) the 'Korean Financial Investment Association' (SRO) may establish standard working rules on investment recommendations which can be jointly enforced by financial investment business entities'.[677]

The WRIR provision of the FISCM Act shows that regulation of investment recommendation isn't a domain which can be well regulated by precise rules.[678] Regulation of financial investment recommendation such as the suitability rule and the 'duty to explain', don't have objective criteria. Instead, such regulation can be subjective; moreover, the situations of the regulatees are heterogeneous. For example, the 'duty to explain' requires 'such sufficiency as to allow the ordinary investor to understand them';[679] however, how much explanation is required isn't objectively stipulated but determined by each consumer's experience and knowledge. The suitability rule requires consideration of each consumer's investment purpose, investment experience, and wealth status; thus, each situation is unique. The 'duty to explain' and recommend a suitable product is itself individual-focused and subjective. Consequently, it is impossible to identify all possible methods of achieving the regulatory goals through precise rules; thus, the regulatory goals should be directly expressed in general standard rules.[680]

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regulation and self-regulation' (2010) available <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2002755> accessed 6th March 2017

677 FISCM Act Article 50

678 Julia Black, 'Using rules effectively' in Christopher McCrudden, *Regulation and Deregulation (*Clarendon Press, 1999) 118

679 See n652

680 Ronald J. Colombo, 'Merit Regulation via the Suitability Rules' (2013) 12 *J. Int'l Bus. & L.*, 1, 13; see also Steven L. Schwarcz, 'Regulating Complexity in Financial Markets' (n629) 263-264, where he argued that '[T]he argument in favor of regulation based on principles is that investment securities and financial markets constantly change, often unpredictably and principles-based regulation is better suited to govern changing scenarios.'; see also Julia Black, 'Using rules effectively' (n678) 107; Blair H. Wallace, 'A Proposal to Refine the Suitability Standard by Quantifying Recommendation Risk and Client Appropriate Risk Levels' (2006) 1 *Brook. J. Corp. Fin. & Com. L.* 231, 232

However, standard-setting by general standard rules is based on the premise of self-governing by the regulated whereby purposive and vague rules are applied to specific situations.[681] If the regulated don't have the ability or will to self-regulate, the vague rules will just be 'rules on the book, not in action' and will be used, if at all, as a means for sanctions ex-post.[682] The WRIR provision is a means to enable the self-regulation which is needed for implementing the general standard rules on financial investment recommendation.

The FISCM Act required that financial institutions should establish their WRIR, but it also allowed that they could use the standard WRIR which the SRO (KFIA) created. According to the FISCM Act, the standard WRIR is only one example of best practice; thus, there is no obligation for financial institutions to adopt it.[683] However, when the standard WRIR was first established in 2009, all financial investment companies adopted the standard WRIR as their WRIR without significant changes.[684] This is the evidence of how the practice of self-regulation is lacking in South Korea's financial industry.

Later, there were complaints from sales employees that the standard WRIR was too strict to apply;[685] however, no financial investment company changed its WRIR. Such reluctance to create their own rules revealed the lack of willingness among the financial institutions to engage in self-regulation.[686] Consequently, the FSS led the establishment of a task force consisting of the SRO and financial institutions in order to improve the standard WRIR.[687] The improved standard WRIR, by providing multiple WRIRs, has enabled financial investment institutions to adopt one as their WRIR.[688] This approach can be described as an attempt which falls between self-regulation and command-and-

[681] See n900
[682] See section 1.5.1.1
[683] FISCM Act Article 50
[684] Financial Supervisory Service, 'Revision of Standard Working Guidance of Investment Recommendation' (n659); out of the total of 88 financial investment companies, 29 adopted the standard WRIR as their WRIR and the remaining 59 adopted it with minor adjustments to some phrases.
[685] See p 1 2 8
[686] Of course, there were other possible causes for this reluctance such as a lack of communication between the regulated and regulator, and the unpredictability of the regulator's application of rules.
[687] Financial Supervisory Service and Korea Financial Investment Association (n683)
[688] Ibid

control style regulation. The process of the changes which the standard WRIR has gone through is a good example of how South Korea's financial industry is bound by command-and-control style regulation and isn't used to self-regulation.

3.2.4 A comparison between the UK and South Korea of the regulatory rules for informational asymmetry

One of the biggest differences between the UK and South Korea regulation for mitigating informational asymmetry between financial institutions and consumers is the range of regulation. In the UK, all communication between financial institutions and consumers is the subject of regulation, whereas in Korea, only investment recommendations and advertisements are regulatory subjects.[689]

However, information asymmetry between financial institutions and consumers isn't problematic only in investment recommendation; it can be present in all transactions of investment products because such products are becoming complicated and specialized. Further, considering the obligation on financial institutions to review the 'appropriateness' of an investment when retail investors decide to invest in a complex financial instrument without any recommendation,[690] the lack of any obligation in communication is an unbalanced approach.

There is no formally announced reason why the South Korean rule-maker limited the application of the 'duty to explain' to only investment recommendation. However, when the standard WRIR was revised in 2010, under the lead of the regulator, one of the revisions was to require that risks about investment products should be explained even when there is no investment recommendation; thus, it can be presumed that the rule-maker had also recognized this issue.[691] Nonetheless, despite the regulator's recognition of the problem, as of September 2017, the statutory regulation has not been revised to

[689] For example, if a consumer visits a financial institution and shows interest in structured bonds and asks for explanation, in the UK, the 'fair communication rule' would apply; however, in South Korea, because an explanation about a product isn't considered to be recommendation or advertisement, there is no such regulatory requirement.

[690] FISCM Act Article 46-2

[691] See p 1 1 1

expand the scope of the 'duty to explain' to areas other than investment recommendation.

The foregoing shows the tardy responsiveness of regulation in South Korea.[692] Because of the principles of 'pre-formulation of state actions by legislation[693] and 'bans on inclusive delegated legislation', the primary legislation must be changed in order to add a new obligation. This process would involve procedural difficulties such as the National Assembly's consent. It would also be difficult to totally change the framework of the FISCM Act, which is designed to operate only on the investment recommendation itself rather than the wider circumstances. The South Korean rule-maker ultimately attempted to solve this problem through the Financial Consumers' Protection Bill, proposed in 2012, by expanding the 'duty to explain' to the circumstance where an ordinary investor asks for information; however, because of various political issues, the Bill has yet to receive the consent of the National Assembly as of November 2017.[694]

The second difference between the two countries worth mentioning is the method of how the rules are written. The *COBS* in the UK makes purposive rules using vague vocabulary. For example, the 'fair communication rule' in the *COBS* states that financial institutions must communicate in a 'fair, clear and not misleading' way. The meanings of the words 'fair', 'clear' and 'not misleading' are purposive and vague. The Guidance provides more detailed circumstances and conditions, but vague vocabulary such as 'appropriate', 'proportionate', 'average', 'balanced', 'complex', and 'sufficient' are used. Although they don't use vague vocabulary, phrases such as 'the relationship is such that the recipient envisages receiving cold calls', 'taking into account the needs of the recipients', and 'all of the information necessary' whose meaning is difficult to pre-define, are also used. The 'fair communication rule' is comprehensive. It can regulate any malpractice about communication with a layperson which cannot be predicted and so cannot be covered by precise rules.

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[692] Stephen G. Breyer, *Regulation and its Reform* (n909) location 1721-1858 (kindle edition), where he said that it was universal issue that 'standards once set prove relatively immune to revision'

[693] See n577

[694] Financial Services Commission, Financial Consumers Protection Bill, Article 19

However, such expandability can cause unpredictability when applying the rule.[695] Without shared norms between the regulator and the regulated, the latter cannot predict the type of communication which the regulator will consider 'fair, clear and not misleading'.[696] In particular, if the level of the regulator's insulation from third party's political influence is low, the issue of uncertainty in applying the general standard rule worsens.[697] The *COBS*'s Guidance, by providing examples, helps to mitigate the disparity between the regulator and the regulated about the extent of the obligation which vague rules require.[698]

In contrast, South Korea's FISCM Act expresses the regulatory requirements in specific language. For example, in the provision of the 'duty to explain', the requirement is to 'explain the details of the financial investment instrument, the risks contingent upon the investment, and other matters specified by Presidential Decree'; there is almost no usage of vague words. The Presidential Decree, which has been delegated to specify other matters, also uses precise words such as the 'structure and nature of investment risks of financial investment instruments', 'matters concerning the fees under Article 58 (1) of the Act', 'matters concerning the terms and conditions of early repayment', and 'matters concerning the cancellation and termination of contracts'. Because of the precise descriptions of obligations, it is clear what financial institutions should do to comply with the 'duty to explain'.[699]

In South Korea, because the requirements of 'duty to explain' are clearly defined, there is a high degree of predictability about applying the rule; however, the problem of under-inclusiveness,[700] which is common to precise rule types, occurs. For example, the FISCM

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[695] See p 1 8

[696] See n900

[697] Ana Carvajal and Jennifer E. Elliott, 'The Challenge of Enforcement in Securities Markets: Mission Impossible?' (2009) 25-26 available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457591> accessed 13th March 2017

[698] See n643; COBS 4.22G-4.2.5G

[699] FISCM Act Article 47; FISCM Act Presidential Decree Article 53; financial institutions must provide no false or distorted information and explain the details of the following five factors: 1) the structure of the financial product, 2) the risks contingent on the investment, 3) the related fees, 4) early payment, and 5) the cancelation or termination of contracts

[700] See section 1.5.1.1

Act doesn't have a requirement equivalent to the requirements about 'comparative information',[701] 'consistency in explanation',[702] 'information about related tax,'[703] and 'past and future performance'[704] which the *COBS* has. However, because the requirements of the 'duty to explain' are precisely written, it is difficult to expand this rule to other situations which are not described. Thus, the requirements which are included in the *COBS* cannot be covered by expanding the application of 'duty to explain' rule of the FISCM Act. A specific example occurred in the UK when a financial institution promoted the maximum return of a structured bond, which was almost impossible in reality, but in theory could be achieved. The FCA sanctioned this promotion as a contravention of the 'fair communication rule';[705] however, in South Korea, this promotion would not be seen as a contravention of the 'duty to explain' because it didn't fall into the category of a false statement and was not regarded as prohibited behaviour by the 'duty to explain'. This demonstrates the under-inclusiveness of precise rules as explained in section 1.5.1.[706]

Unreasonableness, another issue in relation to precise rules, can occur in compliance with the FISCM Act. Unreasonableness means that compliance with rules doesn't make sense because regulatory compliance is far from achieving the rules' goals.[707] Precise rules make obligations clear; thus, the certainty and predictability of regulation is improved. However, because of this clarity, rules can be seen as absolute and unconditional obligations which must be fulfilled irrespective of circumstances. In South Korea, the 'duty to explain' encompasses five factors[708] which must be included in recommendation to ordinary investors. Moreover, because these five factors are explained in detail by sales employees, irrespective of the investor's experience and knowledge level, many

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[701] COBS 4.5.6R
[702] COBS 4.5.8R
[703] COBS 4.5.7R
[704] COBS 4.6
[705] Financial Conduct Authority, 'FINAL NOTICE to Credit Suisse International' (2014); see p165
[706] See p20
[707] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (n99) 58-66
[708] See n699

investors have complained that they had to spend time unnecessarily listening to what they already knew.[709] In this instance, because the FISCM Act precisely stipulates what should be explained, the unintended result was that an explanation was provided to consumers who didn't need it. Such unreasonableness shows that the rules have failed to achieve rationality, a key value of the COB regime.[710]

3.3 Regulation of the bounded rationality of consumers

3.3.1 Rationale for regulatory intervention

It is broadly accepted that people don't always make rational decisions.[711] Since behavioural economics studies emerged, much theoretical and empirical research has supported this theory. In essence, behavioural economics posits that human beings have two thinking systems, intuition and reasoning, and that people use intuition for questions which require reasoning.[712] This proposition lies at the heart of what the term 'bounded rationality' means.

Research has also found investors' bounded rationality in their decisions about financial transactions.[713] Bounded rationality can affect consumers' decisions on financial transactions in the following ways: 1) many financial products are inherently complex for ordinary people, thereby prompting people to simplify their investment decisions and by so doing make errors; 2) although decisions about buying financial products need risk assessments, people tend to use intuition when making such assessments; and 3) many

[709] Financial Supervisory Service and Korea Financial Investment Association (n683)

[710] See p 1 7

[711] Kahneman and Tversky, 'Judgment under uncertainty: heuristics and biases' (1974) 185 *Science* 1124, 1124 -1131

[712] Ibid

[713] Financial Services Authority, 'Financial Services: A Behavioral Economic Perspective' (2010); David de Meza et al, 'Motivating better consumer decisions through behavioral Capability: A Behavioral Economics Perspective' (2014) <http://www.lse.ac.uk/researchAndExpertise/researchImpact/caseStudies/demeza-reyniers-consumer-decisions-behavioural-economics.aspx> accessed June 2016; Nick Chater et al, 'Consumer decision-making in retail investment services: A behavioural economics perspective' (n626); Dimity Kingsford Smith and Olivia Dixon, 'The Consumer Interest and The Financial Market' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP Oxford 2015) n92

financial products are credence products whose value and quality cannot be assessed even after their use, thereby making it difficult to learn from mistakes.[714]

Many types of bounded rationality which are found when consumers decide on their financial transaction show 'present bias'. This bias refers to the attitude placing greater value on the present rather than the future.[715] In the interest rate hedging products scandal in the UK, it was observed that many consumers preferred a swap without an upfront fee to a collar with an upfront fee, without assessing the risk profile of each product.[716] At the stage of decision-making, consumers are vulnerable to influences from salespersons.[717] Consumers show a tendency to trust a salesperson based on her likeable traits rather than seeking objective information such as economic incentive structures.[718] Consumers are also biased by over-confidence that their investments will perform well without rational reasons.[719] In sum, behavioural research in the financial services industry shows that consumers make errors systematically in the process of making investment decisions because of their bounded rationality.

Behavioural studies have proven that the disclosure of material facts isn't enough to protect consumers because of their bounded rationality in processing information.[720] Thus, regulation has moved from 'duty to disclose' to a more paternalistic duty of recommending suitable products and even to direct intervention regarding product design.[721] The suitability rule can be said to be one representative example of paternalism in financial regulation for protecting consumers from the self-harming behaviour.

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[714] Kristine Erta et al., 'Applying behavioural economics at the Financial Conduct Authority' (n624); John Y.Campbell et al, 'Consumer Financial Protection' (2011) 25.1 *The Journal of Economic Perspectives* 91, 91, available at <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC4076052/pdf/nihms311044.pdf> accessed 14th May 2016

[715] David de Meza, et al. (n 713) 17

[716] See n961

[717] David de Meza, et al. (n 713) 18

[718] Ibid 19

[719] Ibid 18

[720] Christine Jolls, Cass R. Sunstein, and Richard Thaler, 'A behavioral approach to law and economics' (1998) *Stanford law review* 1471, 1533-1537

[721] European Capital Markets Institute and Centre for European Policy Studies (n628) 127-128

3.3.2 Regulatory rules for the bounded rationality of consumers in the UK

3.3.2.1 The suitability rule

The *COBS* demands that financial institutions should recommend a suitable product to their consumers when providing a personal recommendation.[722] This rule has significant relevance with over-the-counter derivatives because financial institutions commonly provide a personal recommendation when an over-the-counter derivative is transacted. This situation arises because financial institutions usually design the product and consumers tend to lack knowledge of the recommended financial derivative.[723]

In order to help apply the abstract concept of suitability, the COBS divides suitability into three sub-parts: investment 'objectives', 'financial capability' and 'knowledge and experience'.[724] The first step to ensure suitability is to obtain the following information from a consumer: 1) the consumer's investment objectives, 2) her financial capability and situation, and 3) her knowledge and experience in the investment.[725] Information on investment objectives should include the consumer's risk profile and the purposes of the investment.[726] Information about the consumer's financial capability should include information on her regular source of income, assets, investments, and financial commitments.[727] After understanding the consumer, the financial institution should recommend an investment product which meets the three sub-parts of suitability.[728]

Financial institutions can rely on the information provided by a consumer when assessing suitability unless the information is manifestly inaccurate.[729] When financial institutions cannot obtain the necessary information for assessing suitability, they must not make a

[722] FCA Handbook, COBS, 9.2.1 (1)R

[723] See p 7 3 ; FCA Handbook, COBS, 9.2.8 (1), (2)R; retail and professional clients are covered by this suitability rule; however, the financial institution can assume that professional clients have sufficient 'financial capability' and 'knowledge and experience' to understand the risk of the recommended product.

[724] FCA Handbook, COBS, 9.2.1R

[725] FCA Handbook, COBS, 9.2.1 (2)R

[726] FCA Handbook, COBS, 9.2.2 (2)R

[727] FCA Handbook, COBS, 9.2.2 (3)R

[728] FCA Handbook, COBS, 9.2.2 (1)R

[729] FCA Handbook, COBS, 9.2.5R

personal recommendation.[730] If the consumer keeps asking to proceed with a transaction, the financial institution can arrange the transaction with the consumer's written confirmation.[731] Thus, the suitability rule can be referred to as 'libertarian paternalism' which respects the autonomy of people but tries to help them to avoid self-harming decisions.[732] This accords with the FCA's consumer protection objective which the FSMA 2000 defines as a balance between consumers' responsibility for their investment decisions and providing an appropriate level of care for consumers.[733]

3.3.2.2 The appropriateness rule

The suitability rule is applied when a financial institution provides a recommendation to consumers. The appropriateness rule is applied to transactions which occur without personal advice. The rule requires a financial institution to assess the 'appropriateness' of a transaction requested by a consumer. The financial institution undertakes this requirement by assessing whether the consumer has the necessary experience and knowledge to understand the risks associated with the transaction.[734]

Many consumers invest in financial products without personal advice.[735] In such transactions, the extent of consumers' dependence on financial institutions varies significantly.[736] Transactions where financial consumers have requested specific transactions without any information from the financial institution are 'execution-only' transactions. These are transactions where consumers have the lowest degree of reliance on financial institutions. There are also cases where consumers make purchases after becoming aware of a financial product through a financial institution's advertisement or consultation. In this instance, there is no personal advice, but, the consumers' reliance on the financial institution is very high. Because the suitability rule applies only when a personal advice has been given, the appropriateness rule was created to protect

[730] FCA Handbook, COBS, 9.2.6R
[731] FCA Handbook, COBS, 9.2.7G
[732] Cass R. Sunstein, and Richard H. Thaler, 'Libertarian paternalism isn't an oxymoron' (2003) *The University of Chicago Law Review* 1159, 1163
[733] FSMA 2000, s 1C (2) (d), (e)
[734] FCA Handbook, COBS 10.2.1R
[735] John Armour, *Principles of Financial Regulation (*n95) location 8140-8158 (kindle edition)
[736] Ibid

consumers from their own irrational selections of financial transactions where no personal advice is given.

The appropriateness rule requires that financial institutions must obtain information about the client even for 'execution-only' transactions and if the investment is determined to be inappropriate for the client, the client must be warned of the inappropriateness.[737] When the client refuses to provide information about herself, a warning must be provided that it is impossible to determine the appropriateness of the investment.[738] Compared with the *COB* regime before 2007, which didn't require the appropriateness rule on 'execution-only' services, the *COBS* demands financial institutions to have a more paternalistic role, exceeding the responsibilities of the counterparty of a contract.[739]

3.3.2.3 Product intervention

Product intervention occurs when the regulator is directly involved in the development and distribution of financial products. Such intervention can be ex-ante product authorisation regarding the requirement about specific product characteristics or ex-post prohibition of sales.[740] This intervention is the most paternalistic intervention of COB because the regulator can prohibit the sales of a specific financial product. Product intervention is a regulatory tool for protecting investors whose access to advisory services is limited.

However, because of this paternalistic characteristic, product intervention has various inherent weaknesses. First, fundamentally, whether or not the government can restrict the autonomy of the investor can be subject to challenge.[741] Practically, product

[737] FCA Handbook, COBS 10.3.1R

[738] FCA Handbook, COBS 10.3.2R; this rule doesn't apply to 'professional clients' and 'non-complex' financial instruments because professional clients should be able to sufficiently understand the financial product and because non-complex financial instruments, such as listed shares and money market funds, are simple products with high liquidity.

[739] Niamh Moloney, 'Regulating the Retail Market' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP Oxford 2015) 761-763

[740] Ibid

[741] Péter Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach (*Palgrave Macmillan 2012) 57-5881; see also Anthony I. Ogus, 'The Paradoxes of Legal Paternalism and How to Resolve Them' (2010) *Legal Studies* 30, 61, 63-67

intervention can hinder the innovation of financial products and decrease the welfare of consumers in the long term.[742] In addition, it can incur moral hazard in financial institutions and consumers. Once a financial institution has received permission to distribute a certain product, it may neglect the monitoring of problems related to the product. Moreover, consumers may rely on the government's approval of the product and take less care during the purchase.[743] Because of such side effects, product intervention was not a regulatory tool which was generally used; however, after the 2008 financial crisis, it was adopted by many jurisdictions.[744]

In the UK, the Financial Services Act 2012 conferred on the regulator the authority for rule-making, which can directly restrict the sales of financial products.[745] With this rule-making power, the FCA can create product intervention rules without the consultation which is necessary in the general rule-making process.[746] Product intervention rules can require the inclusion or exclusion of certain product features, the modification of the content of promotional material, and prohibit or restrict the sales of certain products.[747] Transaction contracts which contravene the product intervention rule are unenforceable. Financial consumers who incur losses from such products can seek redress through the FOS or legal action based on the contravention.[748]

For the first time in 2014, the FCA used its product intervention rule-making power to prohibit the sales of contingent convertibles ("CoCos") to retail investors.[749] This example

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[742] Niamh Moloney, 'Regulating the Retail Market' (n739) 761-763

[743] Ibid 762

[744] Niamh Moloney, 'The Legacy Effects of the Financial Crisis upon Regulatory Design in the EU' in Eilís Ferran et al, *The regulatory aftermath of the global financial crisis* (Cambridge University Press, 2012) 5104-5349 (kindle edition); Dimity Kingsford Smith and Dr Marina Nehme, 'Product Intervention: a Legal, Comparative & Policy Analysis' 9-14 available at <https://clmr.unsw.edu.au/sites/default/files/product_intervention_powers_final_2April2015_Kingsford_Smith_and_Nehme.pdf> accessed 9th January 2017

[745] FSMA 2000 s137D

[746] Ibid; such intervention rules have a maximum duration of 12 months. Hence, this rule is called the 'temporary product intervention rule'.

[747] Ibid 31

[748] Ibid

[749] Financial Conduct Authority, Product Intervention (Contingent Convertible Instruments And Mutual Society Shares) Instrument 2015, available at <https://www.handbook.fca.org.uk/instrument/2015/FCA_2015_29.pdf> accessed 9th January 2017; CoCo

shows that, depending on a financial institution's incentive structure and a product's complexity, the UK regulator will use product intervention in addition to the regulatory requirements for advisory services.

3.3.3 Regulatory rules for the bounded rationality of consumers in South Korea

3.3.3.1 The suitability rule

The FISCM Act describes the suitability rule concisely with three provisions. The first obligation about suitability is to assess whether an investor is an ordinary investor or professional investor;[750] the second obligation is to obtain information about the 'investment purpose', 'status of wealth', and 'experience in investment' of an 'ordinary investor' and receive written confirmation from the investor about this information;[751] and the third obligation isn't to recommend products unsuitable to the ordinary investor in light of 'investment purpose', 'status of wealth' and 'experience in investment'. [752]

The suitability rule of the FISCM Act looks concise and precise to comply with; however, on closer examination it is none of these. At first sight, the words which comprise the rule, such as 'purpose', 'status', and 'experience' are not vague. However, the meaning of these words cannot be exactly determined in the financial investment. For example, the meaning of 'investment purpose' can be defined simply as 'making money' or in more complex terms as 'less than 10% probability of loss of principal and profitability of 10% or higher'. It is also unclear whether 'status of wealth' refers to liquid assets, fixed assets, or debt. In addition, 'experience in investment' can be general financial investment experience or experience in a specific type of recommended instrument.

Further, the meaning of 'unsuitable' in light of 'investment purpose', 'status of wealth', and 'experience in investment'" is even more unclear. Considering the innumerable

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absorbs losses when the price of an underlying asset falls below a previously set level; however, CoCos are complex and thus risky for retail clients.

[750] FISCM Act Article 46 (1)

[751] FISCM Act Article 46 (2); see also Stephen B. Cohen, 'The Suitability Rule and Economic Theory' (1971) 80.8 *The Yale Law Journal* 1604, 1634-1635; Willa E. Gibson, 'Investor, Look before You Leap: The Suitability Doctrine Isn't Suitable for OTC Derivatives Dealers' [1997] 29 *Loy. U. Chi. LJ* 527

[752] FISCM Act Article 46 (3)

combinations which can be made from 'investment purpose', 'status of wealth', and 'experience in investment', it is difficult to predefine what is unsuitable.[753] This instance shows that even when clear and concise words are used, the degree of clarity of meaning can substantially vary depending on the context. Similarly, 'the purpose of going to school' and 'the purpose of living a life' both use clear words, but there is a significant difference regarding the determinacy of each phrase.

The FICSM Act delegated the task of defining suitability to the standard WRIR.[754] The KFIA's first standard WRIR in 2009 had quite a rigid structure regarding the suitability rule. Based on the scores of a standardized questionnaire consisting of seven questions, customer investment propensity was categorized into five levels.[755] Investment products were also categorized into five levels of investment risk.[756] Then, for each customer type, the investment product category which could be recommended was stipulated.[757] For example, for a 'stability' customer, only 'ultra-low risk' products were suitable; and for 'seeking stability' customers, only 'ultra-low risk' and 'low risk' products were suitable.

< The first standard WRIR for suitable recommendations >

	Speculative high	High risk	Intermediate risk	Low risk	Ultra-low risk
Stability	Not suitable	Not suitable	Not suitable	Not suitable	
Seeking stability	Not suitable	Not suitable	Not suitable		
Neutral of risk	Not suitable	Not suitable			
Active investor	Not suitable				
Aggressive investor					

The way the financial institutions implemented the standard WRIR was also rigid. Although the KFIA's standard WRIR was just one example which financial institutions

[753] Ronald J. Colombo, 'Merit Regulation via the Suitability Rules' (n680) 13

[754] See n677; FISCM Act Article 50

[755] The five levels of customer investment propensity are 'stability', 'seeking stability', 'risk neutral', 'active investor', and 'aggressive investor'.

[756] The five levels of investment products are 'ultra-low risk', 'low risk', 'intermediate risk', 'high risk', 'speculative risk'

[757] Korea Financial Investment Association, 'Standard Working Rules on Investment Recommendation' (2009) available at <http://www.kofia.or.kr> accessed 13th September 2017

could reference, almost all financial institutions used it for their internal rules without any major changes.[758]

The sales representatives of financial institutions concentrated more on the standard WRIR's wording than its purpose. For example, despite the awareness of the tendency of South Korean consumers to respond more conservatively than their actual risk appetites,[759] financial institutions used consumer risk profiles calculated mechanically based on the scoring system defined by the standard WRIR.[760] In consequence, among one million investors who invested in financial products during 2009, 50.9% invested in 'unsuitable' products after confirming their awareness of the unsuitability of their investments because the financial products they wanted to invest in were beyond their risk appetite scores.[761] It was a paradoxical result that the standard WRIR created for better consumer protection limited regulatory protection. This is just one example of unreasonableness of regulation due to rigid rules.[762]

Recognizing this problem, the KFIA and financial institutions worked jointly to improve the standard WRIR.[763] The newly developed standard WRIR provides multiple criteria for a suitability assessment; thus, a financial institution can select one of the criteria.

3.3.3.2 The appropriateness rule

The appropriateness rule in the FISCM Act has the same name as the *COBS* appropriateness rule; however, the content differs somewhat. In South Korea, the appropriateness rule requires financial institutions to check not only an 'ordinary investor's' 'experience in investment' but also her 'status of wealth' and 'investment purpose' for derivatives transactions, even when there is no investment

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[758] See n683

[759] For culture's influence in risk appetite of people, see Kai LI et al, 'How does culture influence corporate risk-taking?' 23 (2013) *Journal of Corporate Finance* 1, 3

[760] Park Dongphil, 'Suitability rule as investment recommendation as investment recommendation regulation' (2010) 40 *BFL* 56, 66, where the author empirically showed that out of 113,009 consumers, 70% of them had experiences in investing "Speculative" and "High risk" products, but only 46.2% of them were categorized into "aggressive investor" and "active investor" who can be recommended with those products.

[761] Financial Supervisory Service and Korea Financial Investment Association (n683) 9

[762] Robert Baldwin, 'Regulation after 'command and control' in Keith Hawkins, *The Human Face of Law (*Oxford University Press, 1997) 67

[763] Financial Supervisory Service and Korea Financial Investment Association (n683) 9

recommendation.[764] However, under the appropriateness rule of the UK's *COBS*, when a retail client transacts, financial institutions should assess whether the investor's investment experience and knowledge is sufficient to understand the risk of the investment; financial institutions are not required to check the investment purpose or the financial situation of the consumer.[765] In other words, the appropriateness rule of South Korea demands the same obligation as the suitability rule for derivative transactions which occur even without investment recommendations.

The difference in the appropriateness rule in the two countries shows empirically that regulation is crafted to ensure that large-scale consumer detriments from financial instruments are not repeated.[766] Armour terms this the 'how could this have been prevented' approach.[767] The appropriateness rule in South Korea was introduced after the KIKO scandal [768] in order to strengthen regulation of derivatives transactions.[769] One of the major claims by SMEs which incurred losses from the KIKO was that the objective for their over-the-counter derivatives transactions was to hedge the currency rate risk and that they made the transactions without knowing that KIKO was a speculative product. Most of the SMEs which incurred losses from KIKO had had experience in transacting derivatives for currency exchanges before their KIKO transactions and so had experience and knowledge of related investments. Thus, based on the 'could have been prevented' approach, in order to have prevented the KIKO scandal, financial institutions should have been obliged to check not only the investors' experience and knowledge but also the objectives of the investments even when there was no investment

[764] FISCM Act 46-2.1

[765] See n734

[766] Sandra Walklate and Gabriel Mythen, 'Agency, reflexivity and risk: cosmopolitan, neurotic or prudential citizen?' (2010) 61.1 *The British journal of sociology* 45, 45

[767] John Armour, *Principles of Financial Regulation (*n95) Location 3317-3336; see also Christopher Hood, *The Government of Risk: Understanding Risk Regulation Regimes (*OUP Oxford, 2001) 184

[768] See p 1

[769] Financial Supervisory Service, '파생생품 시장 감독체계 개선방안 [Revision on Supervision Framework of Financial Derivatives Markets]' (2008) 13 available at <http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%ED%8C%8C%EC%83%9D%EC%83%81%ED%92%88%20%EC%8B%9C%EC%9E%A5%20%EA%B0%90%EB%8F%85%EC%B2%B4%EA%B3%84%20%EA%B0%9C%EC%84%A0%EB%B0%A9%EC%95%88%20%EB%A7%88%EB%A0%A8&r_url=&menu=7210100&no=26960> accessed 13th September 2017

recommendation. The 'how could this have been prevented' styled regulation reappears in a more extreme form in product intervention regulation, and will be explained in the following section.

3.3.3.3 Product intervention

The regulation of product intervention in the FISCM Act was introduced for reinforcing the regulation of over-the-counter derivatives transactions after the KIKO scandal. Thus, the scope of product intervention is confined to derivatives transactions.

First, a new over-the-counter derivative product for ordinary investors requires prior deliberation by the KFIA.[770] This revision to the FISCM Act was promoted by a member of the National Assembly when the KIKO scandal was at its height in South Korea. However, the financial industry declared its strong opposition to this regulation and even ISDA expressed concerns about the deterioration of South Korea's over-the-counter derivatives market due to this strict regulation.[771] As a compromise, the provision was enacted as a temporary measure from 2009 to 2011.[772]

Second, the FISCM Act required an executive of the financial institution to be nominated as the 'person in charge of derivative business' [773] and for this person to approve each over-the-counter transaction.[774] This provision means more than requiring each over-the-counter derivatives transaction to obtain approval; it also means that if the associated sales practice contravenes the regulation, the person in charge of the derivative business can be held to have regulatory responsibility and also joint civil responsibility[775] with the financial institution.

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[770] FISCM Act 166-2

[771] See http://news.mk.co.kr/newsRead.php?year=2009&no=668748 accessed 23rd March 2017

[772] FISCM Act Addenda (No.10063) 2

[773] FISCM Act 28-2.1

[774] FISCM Act 166-2.1.4

[775] FISCM Act 64 (2) which states that '[W]here any financial investment business entity is liable for damages under paragraph (1) and an executive officer involved in the case is found to be culpable for the cause, such executive officer involved shall be jointly liable for damages with the financial investment business entity.'

Third, the FISCM Act restricted over-the-counter derivatives transactions between financial institutions and ordinary investors to the hedging purposes.[776] This provision means that a financial institution must check an ordinary investor's underlying assets and liabilities and conduct an over-the-counter transaction only for avoiding risk of the underlying factors. In addition, the provision required that listed corporations which were classified as professional investors should be regarded as ordinary investors in over-the-counter derivatives transactions.[777] As a result, triple layers of overlapping regulation, including product intervention, were adopted for over-the-counter derivatives transactions and are preventing the recurrence of scandals such as KIKO.

3.3.4 A comparison between the UK and South Korea of regulatory rules for the bounded rationality of consumers

Regulation for protecting consumers from their bounded rationality in investment decisions, such as the suitability rule, the appropriateness rule, and direct product intervention, is the most paternalistic among COB. These regulations oblige financial institutions to be directly involved in a consumer's decision-making. The purpose is to identify suitable instruments or, as a minimum, to prevent selecting improper products. In addition, for products consistently failing to match a certain group of consumers, the regulator may suspend distribution. In terms of the principal and agent relationship, such regulations impose a fiduciary duty on financial institutions. This duty is to act honestly, fairly, and professionally in accordance with the best interests of their clients in the context of consumers' investment decisions.[778] The way in which the scope is set for such an onerous obligation on financial institutions is important in order to maintain the regulation's effectiveness.

The rule-making style of the UK

[776] FISCM Act 166-2.1.1
[777] FISCM Act 9.5.4
[778] Michelle Lichtor, 'How Suitable is the Language of Suitability in the Modern Era' (2013) 39 *J. Corp. L.* 201, 215

The UK's rule-making system seeks to solve the foregoing problem by providing sufficient information about the regulation.[779] The rulebook provides many Rules[780] and Guidances[781] on suitability and appropriateness requirements in order to explain how to comply with the obligations in various situations. For example, with regard to the suitability, *COBS* explains the necessary information to assess the financial status of a client.[782]

In addition, the UK's *COBS* provides rules to clarify the regulator's requirements so as to reduce the uncertainty of compliance. These rules include provisions stating that when assessing suitability, financial institutions can use information, which isn't manifestly inaccurate, provided by a consumer.[783] In addition, broadly defined Rules with binding legal effects and more specifically defined Guidance with non-binding legal effects are used simultaneously, which enables both flexibility and certainty in relation to the 'suitability' duty.[784]

The rule-making style of South Korea

In contrast, the FISCM Act of South Korea describes the duties of suitability and appropriateness in one short sentence respectively.[785] Moreover, additional explanation

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[779] See p 116-125

[780] See p 88

[781] Ibid

[782] Financial Conduct Authority, *FCA Handbook*, COBS 9.2.2R (3); the necessary information to assess an investor's knowledge and experience (9.2.3R); the need for a financial institution to consider an investor's portfolio when assessing the suitability of a recommendation (9.3.1G (1)); and the situation whereby a suitable product may be unsuitable if the frequency of the transaction isn't in an investor's best interest (9.3.1G (2)) (This provision is for preventing "churning" for commission earning from frequent transactions).

[783] Other example rules are: 'if financial institutions cannot obtain information needed to assess suitability, then they should not make recommendations' (9.2.6R); and 'if a consumer continues to request that a transaction should take place, despite a refusal by the financial institution to make a recommendation, a deal can be arranged with the consumer after receiving the consumer's written confirmation' (9.2.7R)

[784] See p 142

[785] FISCM Act Article 46; With regard to the suitability, it states concisely that '[n]o financial investment business entity shall recommend an ordinary investor to make an investment, if the investment is deemed unsuitable for the investor in light of the investment purpose, status of wealth, experience in investment, etc. of the investor.'; FISCM Act Article 46-2; with regard to the appropriateness rule, it states that '[i]n cases where a financial investment business entity determines that the relevant derivatives, etc. are not appropriate for an ordinary investor taking into consideration the investment purpose, status of wealth, experience in investment, etc. of the ordinary investor, the financial investment business entity shall notify the ordinary investor of the fact.'

about these duties has not been delegated to secondary legislation. Such short descriptions show that these duties address situations too idiosyncratic to define with precise rules. Indeed, it is impossible to predefine suitable or unsuitable financial instruments for so many different circumstances with precise language, which the 'principle of clarity' requires in rule-making in South Korea.[786]

South Korea's FISCM Act delegated the task of defining suitability and appropriateness duties to the standard WRIR,[787] which had no constitutional constraints on rule-making because it was not a statutory regulation. However, the standard WRIR also caused unexpected side effects such as rigid and mechanical application of those duties.[788] As described previously,[789] this example shows how defining the scope of suitability and appropriateness duties is important for determining the effectiveness of regulation. Thus, another implication is that in order to define these duties, extensive knowledge is needed about the front-line practice of investment recommendation and the process of consumers' investment decision-making. The patterns of consumer behaviour in investment decision-making vary significantly by country; thus, the distribution channels and methods are also diverse.[790] For example, the US retail market has a long history of direct household investments in equities and collective investment schemes; UK retail investors have a tendency to favour packaged products; and French investors prefer insurance-related products.[791]

Consequently, because the descriptions of suitability and appropriateness duties must reflect investors' behaviour patterns and the characteristics of the distribution channel of each country, it is difficult to simply copy another jurisdiction's rules.[792] This shows in turn that it is hard for a few elite policymakers in the executive administration and

[786] Julia Black, 'Using rules effectively' (n678) 118

[787] See p 128

[788] See p 129

[789] See p 129

[790] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) n110 (in 4. Investment advice and product distribution)

[791] Niamh Moloney, 'Regulating the Retail Market' (n739) 739

[792] Hideki Kanda and Curtis J. Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51.4 *The American Journal of Comparative Law*, 887, 889

parliament, who have experience in setting broad policy goals but lack expertise about financial products' transactional practices, to define suitability and appropriateness duties in accordance with the country's circumstances.[793]

A comparison of the two styles

A comparison between the UK and South Korea of product intervention regulation shows how product intervention rules can take different forms because of differing rule-making methods. As previously explained with regard to the suitability, under-inclusiveness cannot be avoided if clear and precise vocabularies are used.[794] Then, how would a rule-making body which is incentivized to avoid regulatory failures rather than pursue regulatory success,[795] respond to the under-inclusiveness of precise rules, which can be a potential cause of regulatory failure? By adding more precise rules, under-inclusiveness can be somewhat reduced but will not be completely solved.[796]

The best solution for a risk-adverse rule-maker with precise rules for addressing under-inclusiveness is to introduce a zero-tolerance rule. Zero-tolerance rules completely prohibit actions which may lead to regulatory failure and so make the probability of regulatory failure zero.[797] It is difficult to set an optimal regulatory remit with precise language which inevitably induces under-inclusiveness; however, a rule simply prohibiting whole actions can be made with precise language without difficulty. Hood explained that

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[793] See p 9 1

[794] See p 1 1 6

[795] Christopher Hood, *The Blame Game: Spin, Bureaucracy, and Self-preservation in Government* (Princeton University Press, 2010) 5-11

[796] Frederick Schauer, *Playing by the Rules*: *A Philosophical Examination on Rule-Based Decision Making In Law and in Life* (n111) 17-33; Keith Hawkins and John M. Thomas, 'Rule-making and Discretion: Implications for Designing Regulatory Policy' in Keith Hawkins and John M. Thomas, *Making Regulatory Policy (*University of Pittsburgh Press, 1989) 265-270; Katharina Pistor and Chenggang Xu, 'Law enforcement under incomplete law: Theory and evidence from financial market regulation' (2002) 5-6 available at <http://eprints.lse.ac.uk/3748/1/Law_Enforcement_under_Incomplete_Law_Theory_and_Evidence_from_Financial_Market_Regulation.pdf> accessed 12th April 2017

[797] 'Zero-tolerance' usually describes the enforcement style for deterrence rather than for compliance, but here it is about rule-making style for zero-failure. For example, see Heidi Richards, 'Influence and Incentives in Financial Institution Supervision' in A. Joanne Kellerman, Jacob De Haan and Femke De Vries, *Financial Supervision in the 21st Century* (Springer Berlin Heidelberg, 2013) 77-80; see also Robert A. Kagan, 'Regulatory Enforcement' in David H. Rosenbloom and Richard D. Schwartz, *Handbook of Regulation and Administrative Law (*Marcel Dekker, 1994) 386, where the author explained that empirical studies showed that in response to dangerous accidents, regulations became over-inclusive.

the avoidance of blame is the motivation for many bureaucratic actions and that 'not to provide services that attract blame' is one of the strategies for bureaucratic blame-avoidance.[798] When the blame-avoidance tendency of bureaucratic rule-makers is combined with the political demand for a regulation with a 'could have been prevented' approach,[799] fertile ground is created for zero-tolerance rules to appear. The KIKO scandal in South Korea shows what rules were created with precise rule types when the blame avoidance of bureaucracy and the political demand for 'could have been prevented' regulation came together.[800]

For example, with regard to rules which regulate recommendations for leveraged investment, the UK's *COBS* vaguely states that '[w]hen considering the suitability of a particular investment product which is linked directly or indirectly to any form of loan..., a firm should take account of the suitability of the overall transaction'.[801] However, under South Korea's FISCM Act, recommending leveraged investment to an ordinary investor who has no prior experience of such investment is unconditionally prohibited.[802]

Prohibiting financial institutions from engaging in over-the-counter derivatives transactions with ordinary investors for purposes other than hedging is another zero-tolerance rule of the FISCM Act.[803] In contrast, the UK's *COBS* doesn't have a rule prohibiting over-the-counter derivatives transactions with retail investors where the

[798] Christopher Hood, *The blame game: Spin, bureaucracy, and self-preservation in government* (Princeton University Press, 2010) 101-111; see also Christopher Hood, *The Government of Risk: Understanding Risk Regulation Regimes (*OUP Oxford, 2001) 176-178; see also James Q. Wilson, *Bureaucracy(*Basic Books, 1989) 344-345; see also Keith Hawkins and John M. Thomas 'The Enforcement Process in Regulatory Bureaucracy' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984) 12, where he explained that over-inclusive regulation can occur 'because the agency bureaucracy resists the costs of information and analysis necessary to design rules that reflect unique economic conditions'.

[799] See p 1 3 0

[800] See 3.3.3.3

[801] COBS 9.3.4G

[802] FISCM Act Presidential Decree Article 55, which states 'recommending investment in an investor (excluding professional investors and ordinary investors who have an experience of investment with credit extended under Article 72 (1) of the Act) under the condition that a loan of money shall be granted' is undue recommendation.

[803] FISCM Act Article 166-2

purpose is profit-earning; instead, it states a general requirement to consider an investor's investment purpose and investment experience.[804]

As a result, in South Korea, because leveraged investments are not recommended to those with no prior experience of leveraged investment and because ordinary investors cannot engage in over-the-counter derivatives transactions of which the purpose is profit-earning, the possibility of consumer detriment from these transactions is eliminated.[805] However, transactional opportunity is lost for consumers who have a need for such transactions.[806] This situation is another example of regulatory unreasonableness, which can cause a response from a financial institution's sales representative as follows: '[s]orry, sir, but I'm just telling you what the regulation says. If you don't like it, write to your congressman.'[807]

The 'non-zero failure' regulatory regime[808] announced by the FSA differs in some respects to South Korea's zero-tolerance rule-making style. According to the FSA, a 'non-zero failure' regulatory regime means that the regulator 'doesn't aim to eliminate all failures of firms or lapses in conduct'.[809] The UK regulator rationalized the non-zero failure regulatory regime by explaining that its consumer protection objective is to 'secure the appropriate degree of protection' and that it also should seek to facilitate competition and innovation.[810] Early in the 1980s, Gower summarized this balanced approach of financial regulation in one sentence by saying that financial regulation should not seek to 'protect fools from their own folly' but to 'protect reasonable people from being made fools of'.[811]

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[804] See n967

[805] Strictly speaking, the risk of rulemakers being blamed for regulatory failures

[806] Geoffrey B. Goldman, 'Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed"?' (1995) 95.5 *Columbia Law Review* 1112, n27

[807] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (n99) 77

[808] Financial Services Authority, 'Reasonable expectations: Regulation in a non-zero failure world' (2003) available <http://www.fsa.gov.uk/pubs/other/regulation_non-zero.pdf> accessed 30th March 2017

[809] Ibid 5

[810] Ibid 4

[811] L.C.B. Gower, 'Review of Investor Protection: Report' (HM Stationery Office, Cmd., No. 9215, 1984)

The UK regulator has a very broad rule-making authority for product intervention. The regulator is granted the authority to make rules to prohibit financial institutions from transacting a certain instrument, on the general condition that it is pursuing the objectives of consumer protection and competition.[812] Thus, the UK regulator, without being bound by predefined conditions, such as those of leveraged investment or profit-pursuing over-the-counter derivatives transactions in South Korea, has the broad discretion to prohibit certain products as circumstances require.

[812] FSMA 2000 137D

3.4 Effectiveness of rule-making in the UK and South Korea

3.4.1 Evaluation of effectiveness

The UK rule-making system

If the characteristics of the UK financial regulatory rule-making system are summarized in one word, it would be pragmatism.[813] The UK financial regulatory system sees rules as the means to achieve policy goals. In order to improve the responsiveness of financial regulation, the UK Government has recognized that regulators should be responsible for rule-making rather than government because the latter lacks a specialized understanding of financial market practices.[814]

The rare specific regulatory requirements in the FSMA 2000 statute, and the inclusive delegation for rule-making to the regulator, illustrate the situation well.[815] FSMA 2000 aimed to solve the issue of accountability and transparency, which can occur from inclusive delegation, through the process of consultation and cost–benefit analysis.[816] Inclusive delegation in rule-making can result in infringements of the principle of the separation of power,[817] because the regulator can have legislative and executive power

[813] William James, *Pragmatism (*A Public Domain Book, 1907) 22; he explained that 'the pragmatic method is to try to interpret each notion by tracing its respective practical consequences …if no practical difference whatever can be traced, then alternatives mean practically same thing, and all dispute is idle.'

[814] Michael Blair, George Walker, and Robert Purves, eds. *Financial services law* (n506) para 1.16; see also Pat O'Malley, *Risk, Uncertainty and Government (*Routledge, 2004) 27, 166-177; see also Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) *38,* where they argue that politicians are reluctant to make 'hard choices' about policies which address the sharply conflicting interests of different constituents in society; hence, the politicians delegate their rule-making power to the 'technocrats'.

[815] FSMA 2000, s137A- s137T; see also Richard Stewart, 'Regulation and the Crisis of Legalisation in the United States' in Terence Daintith, *Law as an Instrument of Economic Policy: Comparative and Critical Approaches (*Walter de Gruyter, 1988) 130

[816] Michael Blair, George Walker, and Robert Purves (eds), *Financial services law* (n506) para 1.16; Alaistar Hudson, *THE LAW OF FINANCE* (n413) para 8-02; John Armour, *Principles of Financial Regulation (*n95) location 3317

[817] Susan Rose-Ackerman, 'The Regulatory State' in Michael Rosenfeld et al, *The Oxford Handbook of Comparative Constitutional Law (*OUP Oxford, 2012) location 16176-16213; Paul Craig, *Administrative Law (*Sweet & Maxwell, 2016) para 15-029; Gavin Drewry, 'The executive: Towards accountable government and effective governance?' in Jowell, Jeffrey and Dawn Oliver (eds), *The changing constitution (*Oxford University Press, 2007) 189-190

at the same time; however, FSMA 2000 placed more importance on resolving financial market issues effectively than on the formalities of separation of power.[818]

There is also a form of pragmatism in the sense that the regulator acknowledged the inherent limitation of rules and created a rulebook using various rule types in order to overcome this. An example of such acknowledgment is the FSA's recognition that a precise rule may not actually achieve the purpose of the rule and may tend instead to produce a box-ticking attitude to compliance.[819] In order to counter such an attitude among regulators and regulatees, both of which overlook regulatory objectives and instead focus only on the 'letter of the law', the FSA transformed 'rule-based regulation' into 'PBR' (which is now named 'outcome-based regulation').[820] In rule-making, PBR involves the direct description of regulatory objectives with value-oriented vocabulary.[821]

The *FCA Handbook* contains a high-level rule type, Principle, which is a fundamental guideline for all actions of regulatees.[822] The Rule, which stipulates substantive regulatory requirements, also uses general standard rules written in purposive vocabulary instead of precise descriptions.[823] Using value-oriented standards instead of precise descriptions for the 'Rule' is based on the premise of discretionary intervention by enforcers.[824] Comprehensively and generally defined standard rules improve the responsiveness of the regulatory system to unexpected situations.[825] The FSA's sanction on the manipulation of

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[818] Giandomenico Majone and Pio Baake, 'Regulation and Its Modes' in Giandomenico Majone, *Regulating europe* (Psychology Press, 1996) 16; Margit Cohn, 'Law and Regulation: The Role, Form and Choice of Legal Rules' in David Levi-Faur, *Handbook on the Politics of Regulation (*Edward Elgar Publishing, 2013) 185-186

[819] Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) 217, 238; Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK*(Cambridge University Press, 2010) n244

[820] Financial Services Authority, 'Principles-Based Regulation: Focusing on the Outcomes that Matter' available at <http://www.fsa.gov.uk/pubs/other/principles.pdf> accessed 13th February 2017; see Julia Black, 'The rise, fall and fate of principles based regulation' (2010) available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1712862> accessed 13th February 2017

[821] Ibid

[822] See n519

[823] For example, see n640, n722

[824] Salo Coslovsky et al, 'The Pragmatic Politics of Regulatory Enforcement' in David Levi-Faur, *Handbook on the Politics of Regulation (*Edward Elgar Publishing, 2013) 331-332; Matthew Potoski and Aseem Prakash, 'Voluntary programs, compliance and the regulation dilemma' in David Levi-Faur, *Handbook on the Politics of Regulation (*Edward Elgar Publishing, 2013) 84-86

[825] See p 17

the London Interbank Offered Rate without referring to any contravention of a specific Rule is a good example which demonstrates the responsiveness of the Principle.[826] Moreover, general standard rules can provide the enforcer with discretionary power to prevent regulatory unreasonableness[827] in rigid rule-enforcement based on 'letters of rules'.[828] In sum, the UK financial regulatory rule-making system is intended to enhance the flexibility and responsiveness of regulation through the use of general standard rules.

If rule-making is undertaken with general standard rules, the flexibility and responsiveness of the regulatory system will improve; however, inevitably, other important values of the regulatory system, such as certainty and predictability, will be harmed.[829] General standard rules require discretionary intervention by the enforcer. This strengthens the rationality of regulatory action, but the certainty of regulatory action is weakened. For example, the first Principle of the *FCA Handbook* stipulates that '[a] firm must conduct its business with integrity'.[830] This Principle isn't difficult to understand conceptually but it is uncertain what actions would be in contravention of this rule.

The rulebook of the UK has tried to solve the issue of uncertainty, while maintaining the flexibility of the Principles and Rules written in general standard rules, through the rule type of Guidance. Guidance provides action guidelines for the regulated regarding specific situations. Guidance provides examples of actions which are (non)permissible in specific situations related to a relevant Rule, thereby improving the predictability of Rule

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[826] Financial Services Authority, Final Notice to The Royal Bank of Scotland Plc (2013) available at <http://www.fsa.gov.uk/static/pubs/final/rbs.pdf> accessed 14th February 2017; see also Ruth Fox and Ben Kingsley, *A Practitioner's guide to the UK Financial Services Rulebooks* (n520) 54-55

[827] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (n99) 6-7

[828] Frederick Schauer, *Playing by the Rules*: *A Philosophical Examination on Rule-Based Decision Making In Law and in Life* (n111)

[829] See section 1.3.2 for the trade-off relationship; see also Peter L. Strauss, 'The Rule-making Continuum' (1992) 41.6 *Duke Law Journal* 1463, 1463-1464; John Armour, *Principles of Financial Regulation (*n95) 3168-3184

[830] FCA Handbook, PRIN 2.1.1R

application.[831] Further, because the regulator regards compliance with the Guidance as compliance with a Rule,[832] the certainty of the Rule is also improved.

The prime characteristic, as well as the strength, of the Guidance is that it improves the certainty and predictability of a Rule but at the same time maintains the flexibility and reasonableness of the general standards of the Rule. Guidance is the key element which enables general standard rules (Principles and some Rules) and precise rules (some Rules and Guidance) to coexist in the UK regulatory system. This situation is made possible through the non-exhaustive and non-binding characteristics of Guidance.[833] Because the Guidance is one of many means to comply with a Rule, it is non-exhaustive.[834] Thus, certain activities which are not in contravention of the Guidance can be in contravention of the Rule. In other words, the non-exhaustiveness of Guidance enables the Rule to maintain its flexibility. Another characteristic of the Guidance is that it is 'non-binding'. This means that a contravention of the Guidance doesn't automatically result in a contravention of a Rule.[835] Thus, even for actions that are in contravention of the Guidance, the enforcer is allowed to use discretion to determine whether there is a contravention of the spirit of a Rule. Consequently, with the 'non-binding' characteristic of the Guidance, reasonableness can be maintained in applying a Rule.

In sum, the regulator in the UK can undertake flexible rule-making to achieve policy goals without formalistic constraints. Through rule-making which combines various rule types, the UK pursues both stability and rationality of the regulatory regime.[836] Thus, it is argued here that the UK's rule-making approach is more effective in terms of achieving its stated objectives than Korea's [837]

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[831] Ruth Fox and Ben Kingsley, *A Practitioner's guide to the UK Financial Services Rulebooks* (n520) 36-37

[832] See p 8 9

[833] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997)29-30

[834] See n516

[835] See n518

[836] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 133-137; see also John Braithwaite, 'Rules and principles: A theory of legal certainty' (2002) 27 *Austl. J. Leg. Phil.* 47

[837] While effective rule-making is essential for achieving stability and rationality of a regulatory regime, these values cannot be obtained without an equally effective enforcement. Therefore, the UK's effective rule-making approach alone cannot guarantee effectiveness of the whole regime but provides a strong foundation.

South Korea rule-making system

The word that best describes the South Korean financial regulatory system is legalism.[838] According to Kagan's classification for legalism, the South Korean financial regulatory system is close to 'bureaucratic legalism'. In bureaucratic legalism, a regulatory decision is controlled by formal legal rules rather than discretion, and policy implementation is dominated by a small group of elites rather than public participation.[839]

In South Korea, all substantive regulatory requirements which restrict the actions of the regulated, are stipulated in primary legislation, the most formal type of legislation.[840] The scope of rule-making which the primary legislation delegates to secondary legislation is also limited to technical or procedural matters.[841] Because substantive regulatory requirements must be included in primary legislation, regulatory rule-making is concentrated on a small group of elites of the National Assembly and the executive administration.[842] Because the legitimacy of an Act is obtained through ratification by the National Assembly, participation by the regulated and the public in enacting legislation, such as public hearings, is relatively less important.[843] Thus, rule-making is dominated by the relevant standing committee of the National Assembly and the policymakers in the executive administration.[844] The biggest issue with the rule-making power being held by

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[838] MacCormick defined legalism as 'requiring that all matters of legal regulation and controversy ought so far as possible to be conducted in accordance with predetermined rules of considerable generality and clarity'; see Neil Maccormick, 'The Ethics of Legalism' (1989) 2.2 *Ratio Juris* 184, 184; see also Gunther Teubner, 'Juridification: Concepts, Aspects, Limits, Solutions' in Gunther Teubner (ed.), *Juridification of Social Spheres: A Comparative Analysis in the Areas of Labor, Corporate, Antitrust and Social Welfare Law* (Walter de Gruyter, 1987) where he used the word of 'juridification'; see also John Braithwaite, *Restorative justice & responsive regulation* (n151) 29, where he used the words of 'regulatory formalism'; see also Robert A. Kagan, *Regulatory Justice: Implementing A Wage-Price Freeze (*Russel Sage Foundation, 1978) 6

[839] Robert A. Kagan, *Adversarial legalism: The American way of law* (Harvard University Press, 2009) location 200-214 (kindle edition)

[840] See n571; see also Stephen G. Breyer, *Regulation and its Reform* (n909) location 5449-5470. He explained that the administrative agencies in the US, before New Deal, was a "transmission belt" which just applied congressional statute, which is the role expected from administrative agencies in South Korea.

[841] Ibid

[842] Su-Yong Kim, 'The Current Situation, Problems, Improvements of Legislative Process in the National Assembly (2010) 7 *입법학연구 [Study of Legislation]* 1, 3-4

[843] Ibid 13-14

[844] Ibid 1, 3-4

the National Assembly is late responsiveness.[845] In fast changing financial markets, the late responsiveness of rule-making makes it difficult to respond in a timely way. One example is that the regulator has not been able to make changes to the COB long time even after it became aware of the loophole in the scope of the 'duty to explain'.[846]

The 'principle of clarity', which requires that ambiguity in rules be avoided as much as possible and that rules must be clear and specific, is one of the most important requirements in promulgating legislation.[847] Because all rules must be as clear and specific as possible, there is no rule type such as the general standard rules of the UK Principles and Rules, nor are non-binding and non-exhaustive Guidances.

Even in academia, there is almost no voice which is concerned with the irrationality of regulatory action due to extensive reliance on formal legal rules.[848] Rather, criticism about the Constitutional Court's flexible position on the constitutional principles of 'pre-formulation of state actions by legislation' and 'clarity' is the main research stream.[849] The executive administration also focuses on rigid adherence to those constitutional principles in order to avoid a challenge to the unconstitutionality of the primary and secondary legislation which it drafts.

The biggest problem with rule-making with only precise rules is the rigid and mechanical application of rules, producing behaviour that does not meet the objectives of the rules. In other words, an unreasonable situation is produced where the compliance of rules does not achieve the regulatory objective. The example previously discussed in relation

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[845] See p268

[846] See p 1 1 1

[847] See p 1 0 4

[848] Nam Chul Chung (n582) 1. The author exceptionally argued the executive should have independent discretionary power in the administrative actions in the modern world.

[849] For example, Sangkyung Lee, 'A Study on Relation between the Definitude of Law Principle and the Prohibition of against Unlawfully Broad Delegation of Legislative Power' [2015] 22.3 *Seoul Law Review* 447; Boo-Ha Lee (n600) 1; Woong-kyu Kim, 'Void for Vagueness and Doctrine of Overbreadth in Korea' [2007] 35.3 *Public Law* 1; Seok Jong Hyun, '금융행정영역에서의 법률유보 및 위임입법 법리에 관한 고찰 [Eine Untersuchung zum Grundsatz des Vorbehalates des Gesetzes und der Rechtssetzung der Verwaltung im Bereiche der Finanzverwaltung]' (2003) 196 available at <http://scholar.dkyobobook.co.kr/searchDetail.laf?barcode=4030008687042#> accessed 11th September 2017; Yoon Ki Paik, 'Status and Legal Issues of Administrative Rules in Financial Administration' [2014] 40 *Administrative Law Journal* 55

to this is the explanation of items specified by the 'duty to explain' even to clients who do not need the explanation.[850] Regulatory unreasonableness can induce the regulatees to have mistrust in and be uncooperative with regulation. This is a serious threat to a regulatory regime.

Another problem of rule-making with only precise rules is under-inclusiveness. Because precise rules cannot consider all situations that can arise, they are inherently under-inclusive.[851] To solve under-inclusiveness, the risk-averse rule-maker creates zero-tolerance rules.[852] Zero-tolerance rules eliminate the possibility of 'mis-selling' by prohibiting the transactions themselves but at the same time, social welfare is lost, making it ineffective in achieving the regulatory objective.

In sum, the late responsiveness and unreasonableness of South Korea's rule-making approach makes it ineffective. This is a serious issue per Kagan's argument that the ineffectiveness of rules cannot be cured at the enforcement stage.[853]

3.4.2 Factors that influence the approach to rule-making

Regulatory requirements of COB for transacting financial instruments are conceptually very similar between the UK and South Korea.[854] However, how the requirements are developed into rules is different. The previous section assessed the effectiveness of the different rule-making approaches and concluded that the approach taken by South Korea is ineffective due to late responsiveness and unreasonableness.

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[850] See p 212

[851] See p 20

[852] See p 135

[853] Robert A. Kagan 'Understanding Regulatory Enforcement' (1989) 11 *Law & Pol'y*, 89, 95

[854] For example, with regard to communication between financial consumers and financial institutions, the UK's *COBS* stipulates the obligation of 'fair, clear and not misleading communication' and the FISCM Act of South Korea states that financial institutions have the 'duty to explain' all the major risks and characteristics of a recommended product in a way that a consumer can understand, and both countries also require financial institutions to assess the suitability and appropriateness of the financial products chosen by consumers.; see section 3.2 and section 3.3

This section aims to understand how such conceptually similar regulatory requirements have produced such different forms of rules. Hence discussion turns to how the legal institution and the history of the financial industry have influenced the approach to rulemaking in the comparator jurisdictions.

3.4.2.1 Different legal institutions

Regulation is a social instrument which induces the regulated to outcomes which are difficult to achieve without regulation.[855] This is why regulation always entails the state's exercise of power.[856] The constitution controls the power of the state and allocates this power to other state agencies such as parliament, government, and the courts.[857] Thus, the rule-making of regulation is subject to the restrictions of constitution, which is the foundation of a legal paradigm.[858]

In the area of public law, one of the most important doctrines in democratic constitution is the rule of law.[859] The rule of law has various meanings,[860] but here it accords with the concept which Aristotle explained: '[t]he rule of law is preferable to that of any individual'.[861] From a modern perspective, the rule of law is 'a government of laws and not of men'.[862] The rule of law means that a government's decision should be based on the application of law and not an official's discretion.[863] This approach is based on the trust that a decision made in accordance with the law is predictable and free from the

[855] Anthony I. Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' in Bronwen Morgan and Karen Yeung, *An introduction to law and regulation: text and materials* (Cambridge University Press, 2007) 136
[856] Ibid
[857] Ibid
[858] Karen Yeung, *Securing Compliance: A Principled Approach (*Hart Publishing, 2004) 49-51; Anthony I. Ogus, 'Comparing regulatory systems: institutions, processes and legal forms in industrialised countries' in Paul Cook et al, *Leading Issues in Competition, Regulation and Development* (Edward Elgar Publishing Ltd, 2004) 146 ; Robert Baldwin, *Rules and government* (n108)*17-18;* Justin O'Brien, *Redesigning Financial Regulation (*Wiely, 2006) 1
[859] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) 27-51
[860] Anthony Wilfred Bradley and Keith D. Ewing, *Constitutional and administrative law* (Vol. 1. Pearson Education, 2007) 77-86 Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) *28*
[861] Anthony Wilfred Bradley and Keith D. Ewing (n860) 77
[862] Kenneth Culp Davis, *Discretionary justice: A preliminary inquiry* (LSU Press, 1969) *29*
[863] Ibid *27-51*

abuse of power.[864] The value of the rule of law is that it provides profound social value such as legality, certainty, consistency and accountability.[865] The rule of law is 'a principle of institutional morality', guiding law-making and enforcement. [866] Democratic constitutionalism requires legal certainty and the protection of individual rights in accordance with the rule of law.[867]

However, the authority and responsibility granted to the legislature, judiciary, and administration to implement the rule of law vary significantly by jurisdiction.[868] The constitution of Germany allows the courts to annul particular legislation made by the parliament on the basis that it contravenes the constitution.[869] In addition, German administrative law requires *Rechtsstaat*, which means that governmental intervention must be based on formal legal norms.[870] In the UK, the courts don't have the authority to evaluate the unconstitutionality of legislation. [871] With regard to the UK's administrative law, the focus of judicial review of administrative actions is focused on compliance with appropriate procedures rather than substance.[872] The rule of law is the fundamental legal doctrine of many jurisdictions, but how it is implemented differs. The rule-making process is also affected and constrained by how the rule of law is implemented in the legal system of the jurisdiction.

The UK

The biggest reason for the difference in the method of rule-making between the UK and South Korea is the nature of the countries' legal institutions which includes the

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[864] Ibid *27-51*

[865] Jeffrey Jowell, 'The rule of law today' in Jeffrey Jowell and Dawn Oliver, *The changing constitution* (Oxford University Press, 2007) *16-22*

[866] Ibid *24*

[867] Ibid *24*

[868] Paul Craig, *Administrative Law (*Sweet & Maxwell, 8th edition, 2016) para 1-001

[869] Bronwen Morgan and Karen Yeung, *An introduction to law and regulation: text and materials* (Cambridge University Press, 2007) 138

[870] Matthias Koetter, and Gunnar Folke Schuppert, 'Rechtsstaat und Rechtsstaatlichkeit in Germany' (2010) 3 *Understandings of the Rule of Law in various legal orders of the World, available at <http://wikis. fu–berlin. de/download/attachments/24511234/Koetter+ Germany. pdf>* accessed 19th December 2016

[871] Bronwen Morgan and Karen Yeung, *An introduction to law and regulation: text and materials* (n869) 138

[872] Ibid

constitution.[873] The UK's unwritten constitution recognizes legislative supremacy. Parliament can decide to create any Act with no restriction on the formality or content of the Act.[874] As a result, Parliament can create a provision of delegation which provides a very comprehensive rule-making authority to the regulator.[875] Because the delegated rule-making authority isn't subject to any constitutional restriction on the format of a rule, the regulator can create different types of rules which have varied legal effect.[876] Thus, the rule-making process can be said to focus on regulatory goals.

It can be said that such a pragmatic approach to financial regulation is related to the flexibility of the common law system in which financial regulation operates. Holmes explained that common law is an aggregation of 'experience' and not 'logic'.[877] According to Holmes, under the common law system, the legal form may not change but is reinterpreted in accordance with changing social demands.[878] Common law itself has been called as 'evolutionary pragmatism'.[879] In addition, in common law adjudication, a judge applies vague principles from accumulated cases to a particular case,[880] which is similar to 'principle-based' regulation where a 'principle' provides the general guideline to deal with a specific case.

South Korea

It is true that the constitution of South Korea places more legal constraints on rule-making. The principles of 'pre-formulation of state actions by legislation' and the 'ban on inclusive delegation' require that only primary legislation should stipulate substantive

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[873] Attila Harmathy, 'The Influence of Legal Systems on Modes of Implementation' in Terence Daintith, *Law as an Instrument of Economic Policy: Comparative and Critical Approaches (*Walter de Gruyter, 1988) 256-257

[874] See n544; see also Daniel Fitzpatrick *The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 1305

[875] Daniel Fitzpatrick *The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 1305

[876] See p 8 8

[877] Oliver Wendell Holmes, *The Common Law (*Dossier Press,2016) Location 30 (kindle edition)

[878] Ibid

[879] Ibid; Robert W. Gordon, 'Holmes' Common Law as Legal and Social Science' (1982) *Yale Law School Faculty Scholarship Series, 719,* 721-722, available at <http://digitalcommons.law. yale.edu/fss_papers/1371> accessed 3rd February 2017; Frederick Schauer, *Playing by the Rules*: *A Philosophical Examination on Rule-Based Decision Making In Law and in Life* (n111) location 3127-3152

[880] Frederick Schauer, *Playing by the Rules*: *A Philosophical Examination on Rule-Based Decision Making In Law and in Life* (n111) location 3103-3131 (kindle edition)

requirements. The principle of clarity also restricts general standard rules from being used in rule-making. However, it cannot be said that the constitution explains everything about the legalism in South Korea's regulatory system. The Constitutional Court recognized that delegating rule-making authority to technocratic officials in executive administration and using vague language when making rules is unavoidable.[881] Despite the Constitutional Court's relatively flexible approach to rule-making, the executive administration applies strict formalistic constraints to itself in rule-making.[882] According to some commentators, Korean people distrust the equality of the enforcement of law; thus, such distrust demands precise rule-making and inflexible enforcement, which can constrain discretionary power.[883] Such an analysis explains that the root of distrust is the lack of legitimacy of the dictatorial government, which seized power until the end of the 1980s.[884]

3.4.2.2 Different histories of financial regulation development

The UK

Financial regulation in the UK has evolved through various experimental reforms.[885] Especially since the 1980s, the UK has been a pioneer among industrialized countries in financial regulatory reform.[886] The evolution of financial regulation started with an extreme form of self-regulation called 'club regulation' and developed in the direction of

[881] See n606
[882] See n612
[883] For example, Bong-Chul Choi, 'Korean Legal Culture and the Tasks of the Rule of Law' (2001) 11.1 *법학연구 [Legal Study]* , 75, 83; Jongcheol Kim, 'Government Reform, Judicialization, and the Development of Public Law in the Republic of Korea' (n610) 102
[884] For example, see Choi Song Hwa, '한국에서의 민주주의와 법치주의의 역사적 전개 [Historical Development of Democracy and Rule of Law in South Korea' [2007] 36.1 *Public Law;* Jongcheol Kim, 'Government Reform, Judicialization, and the Development of Public Law in the Republic of Korea' (n610) 107-108; Kwan Hun Young, '한국관료제에 있어서 사법적 통제의 단절원인과 복원과정 [Legal Control in Korean Bureaucracy]' (2013) 19.3 *정부학연구 [Study of Administration]*, 72-73
[885] Julia Black, 'Regulatory Styles and Supervisory Strategies' (n819) 218-240; see also Richard Rawlings, 'Introduction: Testing Time' in Dawn Oliver et al, *The Regulatory State: Constitutional Implication (*Oxford University Press, 2010) 4
[886] Michael Moran, *The British regulatory state: high modernism and hyper-innovation* (Oxford University Press on Demand, 2003) location 32 (kindle edition); see also Julie Froud, et al. *Controlling the Regulators* (n276) 1

expanding governmental intervention.[887] The regulatory failure experienced under the old regulatory system was the impetus for evolution into the next stage.[888] The two significant characteristics of financial regulation in the UK are proactive reform of the regulatory system and the consistent tradition of self-regulation.[889]

Club regulation[890] was the nickname of regulation in the financial services industry before the enactment of FSA 1986. Marquand explained club regulation as follows: '[t]he atmosphere of British government was that of a club, whose members trusted each other to observe the spirit of the club rules.'[891] Moran contended that the regulation of the 'club' by elites was created to protect their interests from the emerging industrial middle class in the Victorian age.[892] Thus, financial regulation in the UK commenced with the aim of elites to govern themselves without governmental interference.[893] Some commentators explained that club regulation is one part of the British elitist tradition in the political system.[894]

In the 1970s, with the globalization of the financial market in full swing and new financial institutions from abroad entering the local UK market, regulation by a club of inner circle

[887] Michael Moran, *The British regulatory state: high modernism and hyper-innovation* (n886) Location 51-73 (kindle edition)
[888] Ibid location 32 (kindle edition)
[889] Rob Baggott, 'Regulatory reform in Britain: The changing face of self-regulation' [1989] 67.4 *Public Administration* 435; he explained that Britain had always been the heaven for self-regulation; see also Anthogy I. Ogus, 'Rethinking Self-Regulation' in A Reader on Regulation (Oxford, 1998) 374
[890] Michael Moran, 'The rise of the regulatory state in Britain' (2001) 54.1 *Parliamentary Affairs* 19, 23
[891] David Marquand, *The unprincipled society: New demands and old politics* (London: J. Cape, 1988) 178
[892] Michael Moran, *The British regulatory state: high modernism and hyper-innovation* (n886) Location 51-73; Daniel Fitzpatrick, *The Politics of Regulation in the UK The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 77
[893] Daniel Fitzpatrick, *The Politics of Regulation in the UK The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 1339-1370
[894] Anthony P. Tant, *British government: The triumph of elitism: A study of the British political tradition and its major challenges* (Dartmouth Publishing Company, 1993); Patrick Diamond, *Governing Britain: Power, politics and the prime minister* (IB Tauris, 2013) 21; Mark Evans, *Constitution-making and the Labour Party* (Basingstoke: Palgrave Macmillan, 2003) 313; Christopher Hood, et al*, Regulation inside government: Waste watchers, quality police, and sleaze-busters (*Oxford University Press, 1999) 72; Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (Hart Publishing, 2015) location 16076 (kindle edition)

members couldn't work.[895] Club regulation was based on the premise that constituents were similar, sharing common norms; however, with new entrants in the market, the premise was no longer held. In response to the changed environments, the FSA 1986 created a hybrid regulatory regime where statutory regulation and self-regulation by SROs was combined.[896] The hybrid regulatory regime represented regulatory innovation with self-regulation of SROs, supported by the statutory agency, the SIB.[897] The regime was a cooperative structure of public–private regulators, where the financial industry maintained its self-regulatory power but the government defined the outline of regulatory requirements. Then, with the FSMA 2000, the hybrid regulatory structure moved completely to centralized regulation where the integrated regulator, the FSA, held exclusive regulatory power.[898] However, even under this centralized regulatory structure, the tradition of self-regulation has continued with PBR in which self-regulation is one of the indispensable constituents.[899]

Self-regulation is a requisite condition to adopting general standard rules. General standard rules provide flexible interpretation and enforcement; however, they can only work successfully when the constituents in the regulatory regime share common norms and culture.[900] Without shared norms between the regulated, enforcers, and rule-makers, general standard rules cause inefficiency and mess. For example, if the regulated, enforcers, and rule-makers have different understandings about the expected level of caution which the general standard rule of 'act with integrity' requires in certain situations where an investment product is recommended to a consumer, the general standard rule would create more disputes than solve them. However, having common norms, culture, and understanding between the regulated and regulators isn't easily achieved; it requires the regulated to have experience of governing their behaviours and

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[895] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 52-53; see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 20944 (kindle edition)

[896] See n470; see also Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' (n547) 246-247

[897] Michael Moran, *The British regulatory state: high modernism and hyper-innovation* (n886) Location 73-96

[898] See n480

[899] Julia Black, 'Regulatory Styles and Supervisory Strategies' (n819) 220

[900] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 36-37

to communicate with the regulator about interpretation of rules.[901] Such experience and practice of communication cannot be obtained without a long history of self-regulation. The current flexible rule-making system of the UK was achieved through imaginative and bold experimentalism[902] and historical coincidence,[903] but it couldn't have been achieved without the tradition of self-regulation.

South Korea

In contrast, South Korea had almost no experience or tradition of self-regulation in the financial industry. It can be said that financial regulation in South Korea has never been in any other form than 'command and control'.[904] The government makes precise rules and requires that the regulated comply; the government then sanctions any contravention. Indeed, the command and control style of regulation isn't only limited to the financial industry but to the overall regulatory culture in South Korea.[905] Some commentators have argued that such a top-down regulatory culture is connected to the Confucianism culture where social hierarchy is important.[906] The commentators have explained that even after the adoption of the Western legal system in the nineteenth

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[901] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 30-44; see also Financial Services Authority, 'Principle-based regulation: Focusing on the outcomes that matter' (n820) 2, where the regulate said that '[w]e will invest in developing the capabilities of our people so that they have the experience, expertise, judgement and communication skills to make principles-based regulation work.'

[902] Julia Black, 'Regulatory Styles and Supervisory Strategies' (n819) 218-240

[903] Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 91-100; she explained that the three-tier regulatory rule structure consisting of Principle, Rule and Guidance was crafted as a coincidental result to resolve the power game between SIB and SROs through the New Settlement; see also Iain MacNeil, 'The Future for Financial Regulation: The Financial Services and Markets Bill' (1999) vol 62 *The Modern Law Review* 725, n49

[904] Choi Sung Rak, 'Study on Characteristics of Korean Self-Regulation: focused on Self-Regulation Classification' (2007) *Korean Public Management Review* 73, 93

[905] Sa Gong Young Ho, '규제문화와 규제이념의 충돌 [Crash between Regulatory Culture and Regulatory Ideology' (2005) 5.2 *한국정책연구* [*Study of Korean Policy]* 43, 45-46

[906] Under historical Confucianism, an absolute bureaucratic system with the king at the centre exerted unlimited power on the people; moreover, the teachings of Confucianism required obedience by the officials to the king and by the people to the officials; ibid; see also Park Jong Min, '온정주의 정치문화와 권위주의 통치의 타당성 [Rationale of Paternalism and Authoritarianism]', [1996] 30.3 *한국정치학회보 [Journal of Korean Politics]*, 105; see also Oh Suk Hong, '행정만능의 보도 [The Weapon of Administration Omnipotence]', *신동아 10 월 [Shin Dongan October]* [1998] 300

century, Confucianism's tradition of command and control still affected the regulatory culture.

Another important reason that a culture of self-regulation was not able to take root in South Korea was because the development of the financial industry was led by the government so that funding could be provided to the manufacturing sector, which contributed to exports.[907] Thus, financial regulation was made and enforced with the objective of nurturing the manufacturing industry. Moreover, until the 1997 Asian financial crisis, the Treasury was directly involved in the management of financial institutions. Consequently, South Korea didn't have an environment where self-regulation could grow.[908]

3.4.3 Compatibility of South Korea with the COB

The South Korean government explicitly stated that it referenced similar regulation in the UK and the US when promulgating the COB in the FISCM Act.[909] Kanda and Milhaupt argued that for a successful transplant between jurisdictions with different institutional and cultural conditions, there should be a good fit between the host country's legal infrastructure and the transplanted regulation and, at a macro level, the host country's stage of social development should needs the transplanted regulation.[910] Without this, there is a significant possibility that the transplanted regulation will not work harmoniously with the moral norms of the host country, a situation which can trigger regulatees' resistance.[911] This section looks at the micro and macro fit between the South Korean regulatory environment and the transplanted COB, and analyses the cause of regulatory failure in South Korea through that lens.

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[907] Kwon Oh Chul and Kang Ju Hoon, *한국경제의 이해 [Explanation of Korean Economy]* (Samyoung Sa, 1995) 99-101

[908] Ibid

[909] Ministry of Finance and Economy, 'Explanation Material on FISCM Act Bill' (n563) 5-57

[910] Hideki Kanda and Curtis J. Milhaupt (n792) 891; see also Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'Economic development, legality, and the transplant effect' [2003] 47.1 *European economic review* 165

[911] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) Location 1001-1673 (kindle edition)

The macro perspective

From a macro perspective, the South Korean economic environment needed a reinforced regulation for investor protection. After the 1990s when the South Korean capital market was opened to the global market, the financialization[912] of the economy had progressed rapidly.[913] This financialization could be found in many areas. The ratio of financial assets[914] to gross domestic product (GDP) steeply increased, beginning in the mid-1990s.[915] This increase meant that the economy's constituents, businesses and households, had increased capacity to invest in the financial market. The growth of household financial assets from 22.7 million Korean Won in 2002 to 41.1 million Korean Won in 2009 also reflected the increase.[916] Of these household financial assets, the proportion of investments with loss risk, such as bonds, stocks, and collective investment schemes, was on a continuous growing trend from 22.7% in 2002 to 31.1% in 2009.[917] This meant that household financial assets were moving from deposits with no loss risk to investment instruments with higher risk. Especially from the early 2000s, when the low-interest rate trend began, household demand for medium-risk and medium-return investments grew. Thus, the issue of structured products such as equity-linked deposits increased significantly.[918]

Financial investments in the business sector were also rising continuously. In manufacturing, the ratio of investment assets to total tangible assets increased from 15%

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[912] Gerald A. Epstein (ed), *Financialization and the world economy* (Edward Elgar Publishing, 2005) 3 where financialization was defined as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'

[913] Park Chanwoon and Hong Soonman, '한국경제금융화의 특성과 함의 [The Characteristics and Meaning of Financialization of Korean Economy]' [2016] *The Korean Sociological Association Conference*, 145

[914] Credit asset including deposits, shares, bonds and promissory notes (source: e 나라지표, http://www.index.go.kr)

[915] The ratio of financial assets to GDP = total financial asset 총금융자산 ÷ GDP (source : e 나라지표, http://www.index.go.kr)

[916] Hyundai Research Institute, '세계경제패러다임변화와 한국경제 [The Paradigm Shift of Global Economy and Korean Economy]' (2010) 10-13 *Weekly Economy*, 1, 1-14

[917] Ibid 4

[918] Yoon Sunjoon, '투자자보호를 위한 구조화상품의 규제[Regulation of Structured Products for Investor Protection] (2012) 25-4 *Study of Finance*, 521, 529

in 1990 to 40% in 2005.[919] The use of derivatives for hedge purposes by businesses also increased rapidly. There was also a significant increase in the proportion of listed SMEs using derivatives, from 4.5% in 2000 to 34.8% in 2008.[920]

The number of disputes between consumers and financial institutions over investments also rose as the financialization of the South Korean economy progressed and the use of financial investment assets and derivatives by households and businesses grew. Before the enactment of the FISCM Act, there was no statutory regulation about 'suitability' or the 'duty to explain' regarding investment recommendations by financial companies.[921] However, even without such statutory regulation, the 'duty to protect customers' of financial institutions was established through court cases.[922]

The first case where the financial institution's 'duty to protect customers' was recognized was Case93Da26205 in 1993. Here, the Supreme Court defined the contravention of the duty to protect customers.[923] In this adjudication, the concept of 'duties to protect customers' included two sub-duties: first, the duty to avoid hindering an investor's accurate understanding of an investment and second, the duty to avoid actively recommending a transaction which involves excessive risk in consideration of the investor's investment circumstances.[924] It is noteworthy that the duties of the case are each similar to the 'duty to explain'[925] and the suitability rule[926] of the FISCM Act, which would be introduced much later.

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[919] Cho Bokhyun, 'Development of Financial System and Financialization in Korea' (2010) 29 (1) *Analysis of Society and Economy*, 254, 268-269

[920] Park Sang-Su and Lee A-Young, 'The Characteristics and Determinants of Derivatives Use by Korean Small Firms' (2010) 15 (3) *Study of Accounting*, 201, 206

[921] Sung Jai Choi, '고객보호의무법리에 대한 연구 [Economic Implication of KIKO Decisions and Its Development]' (2010) 11 (1) *Study of Securities Law*, 1, 20

[922] Ibid 10-12; see also section 5.2.1.1

[923] *Supreme Court 93 Da 26205,* which stated that "When all factors are comprehensively considered, including the procedures and methods involved in the transaction, the customer's investment circumstances, the transaction risk, extent of explanation about the risk, etc., the recommendation activity can be seen as abandoning the 'duty to protect customers', which hinders the general investor, who lacks experience, from accurately understanding the risk which is inevitable with such a transaction or which actively recommends a transaction which involves risk which is excessive considering the investor's investment circumstances."

[924] Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender]* (Parkyoungsa, 2000) 163-189

[925] See section 3.2.3

In the period before the FISCM Act was enacted, when there was no explicit statutory regulation overseeing investment recommendation, the principle of the 'duty to protect customers' was developed through the case law. This situation shows that the South Korean financial market had a pressing need for the regulation of investment recommendation. In sum, as the financialization of the South Korean economy progressed, the constituents of the economy had more exposure to risky financial investments; thus, there was increasing need for a financial consumer protection device.

The micro perspective

From a macro perspective, it can be said that the environment was being set for the transplant of COB; however, from a micro perspective of South Korean legal culture and the regulatory system, the same cannot be said.

The South Korean regulatory regime was not ready to adopt a regulation based on a general standard rule. As already explained, COB of the transaction of financial instruments, such as the 'duty to explain' and the 'suitability rule', regulates circumstances which are idiosyncratic; thus, it is inevitable that rule-making is based on general standard rules.[927] However, this approach isn't as simple as writing a rulebook with general standard rules. In order for general standard rules to work in the regulatory space, the UK experience shows that it is necessary to have well-functioning self-regulation by the regulated, where vague and purposive rules are interpreted and applied.[928]

A pre-condition for general standard rules to work is the trust among the constituents in the regulatory space;[929] the trust of the general public and the rule-maker that the general standard rules will be enforced without the abuse of discretion by the enforcer or capture by the regulated; the trust of the rule-maker and enforcers that the regulated

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[926] See section 3.3.3

[927] See p 1 1 6

[928] See section 4.1.3

[929] Julia Black, 'The rise, fall and fate of principles based regulation' (n820) 22-23; see also Julia Black, 'Talking About Regulation' (1998) 1 *Public Law* 77, 77-78; see also John Braithwaite, 'Rules and principles: A theory of legal certainty' (n836) 47; Albert J. Reiss, 'Selecting strategies of social control over organizational life' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984) 27

properly understand the general standard rules and can self-govern based on them; and the trust of the regulated that the enforcer will not interpret and enforce the general standard rules in a way which contradicts the shared norms in the regulated community.

In order for trust to be established between constituents in the regulatory space, it is important that there is a close conversation between the regulator and the regulated.[930] However, in South Korea, where regulatory tradition has been of the command-and-control style, there has been no need for conversation between the regulator and the regulated; thus, there was not an environment for trust to grow.[931] Black argued that PBR promotes conversation between the regulator and the regulated and strengthens trust; but Black also pointed out that if there is no trust, such regulation cannot exist in the first place and that this is the 'ultimate paradox' of PBR.[932]

What would happen if a command-and-control style regulatory regime, which lacks trust between constituents in the regulatory space, transplanting general standard rules without any other complements? This can result in a situation where the regulated don't know what to do. The regulated, whose experience is that of command-and-control style regulation, may have no idea about how to comply with general standard rules. For those regulated with experience of only complying with bright-line rules, vague rules, such as 'not to recommend investment unsuitable for the investor in light of the investment purpose, status of wealth, experience in investment', may be too complex and unclear to comply with. An example of this was where financial institutions in South Korea couldn't create their own WRIR[933] in relation to the 'duty to explain' and the 'suitability rule'; instead, they all copied the standard WRIR.[934] This is one possible result of what Black expected from general standard rules.[935]

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[930] Julia Black, 'Regulatory Conversation' (2002) 29.1 *Journal of Law and* Society, 163, 171-173

[931] See p 1 5 2

[932] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (2008) LSE Law, Society and Economy Working Papers 13/2008, 35-36 available <www.lse.ac.uk/collections/law/wps/wps.htm> accessed 6th April 2017

[933] See p 1 1 5

[934] Ibid; see also Ehud Kamar, 'A Regulatory Competition Theory of Indeterminacy in Corporate Law' (1998) 98 *COLUM. L. REV.* 1908, 1910-1912, where the author explained that other states of the US couldn't easily copy

The example of South Korea shows that proxy rules [936] crafted to alleviate the regulatee's difficulty in complying with the general standard rule not only counters the effectiveness of the general standard rule but can create regulatory unreasonableness.[937] In the command-and-control regulatory regime, a proxy rule for a general standard rule can cause 'blind compliance', which means that the regulated comply with the proxy rule without giving attention to the rule's purpose.

Blind compliance can be said to have different features from 'creative compliance'. Creative compliance occurs where the regulated comply creatively with the words of the rules and are also aware of the spirit of the rules. Blind compliance occurs where the regulated comply mechanically without any idea of the spirit of the rules. Creative compliance is an expensive tactic which large corporations and elite legal professionals can craft, [938] while blind compliance reflects the regulatee's low investment in understanding and complying with regulatory norms. However, both pose challenges for legal control.

In a command-and-control regulatory regime, there is a greater possibility that the rule enforcer will over- or under-enforce the general standard rules. In a regulatory regime, where the level of trust among its constituents is low, precise rules are the devices which regulate not only the regulated but also the regulator.[939] When the general public doesn't have confidence that the regulator will use its discretionary power fairly, they

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Delaware corporate law which was highly indeterminate and so gave comparative advantage to it to attract large companies because other states' legal infrastructure such as legal profession was not prepared to apply the indeterminate law to real cases.

[935] Julia Black, 'Using rules effectively' (n678) 106-107

[936] See n666; for example, the proxy rule for the 'duty to explain', requiring receipt of the consumer's confirmation that she fully understands what is explained.

[937] See p１１３; see also Pistor Katharina and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory' (2003) *SS-RNWorking Paper* 33 available <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=343480> accessed 10th April 2017

[938] Doreen McBarnet and Christopher I. Whelan, 'Creative Compliance and the Defeat of Legal Control: The Magic of the Orphan Subsidiary' in Keith Hawkins, *The Human Face of Law (*Oxford University Press, 1997) 178

[939] Christopher Hood, et al, *Regulation inside government: Waste watchers, quality police, and sleaze-busters* (n894) 13-17; see also Neil Gunningham, 'Strategizing compliance and enforcement' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 207, where he argued that people's mistrust of government in the US resulted in 'adversarial legalism' in the US regulatory space.

demand precise rules for easy monitoring of the regulator's exercise of power.[940] The regulator, which has always been exposed to the social demand for 'compliance accountability' to rules,[941] can be reluctant to rely on general standard rules. This reluctance is because the regulator can feel difficult with proving that enforcement action complies with the vague rules (under-enforcement). Alternatively, in a situation where the regulator is forced to resort to the general standard rules by, for example, outside political pressure, it can take a conservative and harsh stance in applying rules to avoid blame for weak enforcement (over-enforcement).[942] The thesis will empirically examine this in the following chapter.[943]

In a jurisdiction where the tradition of self-regulation is weak and where trust is lacking among the constituents in the regulatory space, how can the COB, such as 'fair communication rule' and the 'suitability rule', be transplanted? The answer is to set a policy goal of increasing the practice of self-regulation instead of creating proxy rules which have a counter-effect. A good example of this is the FISCM Act of South Korea, which required financial institutions to establish the WRIR. Even though it didn't work well in South Korea, it was transitional attempt which a jurisdiction with no tradition of self-regulation could try.[944] Ayres and Braithwaite argued that regulation should be responsive to industry structure.[945] They emphasized the responsiveness of regulation from an enforcement perspective. Rule-making must be responsive to the regulated community's culture, attitudes towards regulation, and the current underpinning legal structure of the entire society.

Conclusion

[940] See p 1 4 9

[941] Paul C. Light, *Monitoring government: Inspectors general and the search for accountability*. (Brookings Institution Press, 2011) 12-16

[942] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 29-32

[943] See p 2 1 0

[944] Ultimately, the regulator led the creation of a standard WRIR.

[945] Ian Ayres and John Braithwaite, *Responsive regulation: Transcending the deregulation debate* (Oxford University Press on Demand, 1992) 4-6

This chapter has reviewed the history of financial regulation in the UK and South Korea. In the UK, there have been three paradigm-shifting legislative changes: the PFI Act in 1939, the FSA 1986 and the FSMA 2000. Despite the significant changes, self-regulation by the financial services industry has always been at the base of the regulatory regime. Under the current FSMA 2000 structure, the primary legislation sets the framework of financial regulation and provides the regulator with power of rule-making of substantive requirements. The regulator's wide rulemaking authority can also be seen as part of the tradition of self-regulation.

In South Korea, financial regulation has been marked by a top-down approach led by the government. As the financial industry had been recognized mainly as a source of funding for the manufacturing industry, the COB for investor protection was recently adopted through the FISCM Act in 2011. The rule-making approach has been also top-down in that all substantive requirements are defined in the primary legislation. Thus, main requirements of the COB such as suitability and "duty to explain" are all stipulated in the primary legislation, FISCM Act. This causes the late responsiveness of the COB regime.

Such historical and institutional differences between the two countries also brought about big differences in rule-making methods. As the name PBR[946] represents, UK rules are made with purposive and vague rule-types. To complement the uncertainty of these rule-types, informative and non-binding rule-types are introduced through Guidances. On the other hand, in South Korea, all rules are made to be precise and clear. Precise and clear rules are partly the result of constitutional constraints but they are also due to the tendency of the administration to put more importance on the certainty of the regulatory regime.

The contrasting rule-making styles of the two countries created different outcomes. South Korea experienced rigid interpretation and application of rules, a problem of precise and clear rules, and so produced results that deviate from the objectives, damaging the rationality of the COB regime. In the UK, by using various rule-types such as Principles, Rules and Guidances, the foundation was established for the regulatory

[946] Principle-Based Regulation

regime to achieve both stability and rationality. This provides the answer to the third research question in relation to rulemaking.

Lastly, the chapter discussed the compatibility of COB with South Korea's macro and micro circumstances. It has been shown that although the South Korean economy's financialization (macro circumstances) demanded the COB, South Korea's command-and-control regulatory culture (micro circumstances) was inappropriate to general standard rules of the COB.

CHAPTER IV. PUBLIC ENFORCEMENT OF COB IN OTC DERIVATIVES TRANSACTIONS

Introduction

Chapter III analyzed the 'law on the books' related to transactions of over-the-counter derivatives. This chapter examines the 'law in action'. If the objective of business regulation is changing the behaviors of the regulated, then enforcement is the final stage of achieving these objectives.

As each jurisdiction's regulator is constrained by different regulatory environments, such as legal institutions and political, human and financial resources, their enforcement strategies can differ.[947] Even with the same standards, the outcome of a regulatory regime could vary depending on the manner of enforcement.[948] The chapter analyzes public enforcement cases to understand how the two countries' COB is enforced. Then, based on the case studies, the chapter provides an in-depth analysis of the enforcement strategies adopted by the UK and South Korea and shows their outcomes, which answers the third research question.

4.1 Public enforcement in the UK

This section first considers sanctioned and consumer redress cases related to 'mis-selling' of over-the-counter derivatives in the UK, thus illustrating how the UK regulator interprets the rulebook, and what the regulator requires from financial institutions in the market place.

4.1.1 Public enforcement cases: 'mis-selling' of OTC derivatives in the UK

[947] Keith Hawkins and John M. Thomas, 'The Enforcement Process in Regulatory Bureaucracy' (n798) 10

[948] Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'The Transplant Effect' [2003] 51 *Am. J. Comp. L*, 163; see also Paul Fenn, and Cento G. Veljanovski, 'A Positive Economic Theory of Regulatory Enforcement' (1988) 98.393 *The Economic Journal* 1055, 1055

4.1.1.1 Disciplinary actions

Disciplinary actions against financial institutions that contravened regulatory requirements serve as a tool for public enforcement of regulation. This section examines how binding 'Rules'[949] (expressed in vague and purposive language) and informative 'guidance'[950] (expressed in relatively specific language in the UK regulatory rulebook) have been enforced through individual cases. Since the establishment of the regulator in 2000, there have been eight cases of disciplinary actions against 'mis-selling'' of over-the-counter derivatives. In most cases, the breached rules included the 'fair, clear, and not misleading communication'[951] rule and the suitability[952] rule.

Table 1: Regulator's sanction against 'mis-selling' of over-the-counter derivatives in UK

Financial institutions	Product	Contravention	Year of sanction	Fine (A) (£)	Number of related consumers	Invested amount (million £) (B)	Ratio (A/B) (%)
Chase de Vere Financial Solutions	structured capital at risk products	misleading communication	2003	165,000	259	No information	
Lloyds TSB Bank	structured capital at risk products	unsuitable products	2003	1,900,000	51,000	720	0.26
Credit Suisse UK	structured capital at risk products	unsuitable products	2011	5,950,000	623	1,099	0.54
Savoy Investment Management	investment advice	suitability procedures breach	2012	412,000	4,000	No information	
Santander UK	structured capital at risk products	misleading communication	2012	1,500,000	178,000	2,700	0.06
J.P. Morgan	investment advice	suitability procedures breach	2013	3,076,200	3,000	No information	

[949] See p 8 9
[950] Ibid
[951] FCA Handbook, COBS s4
[952] Ibid s9

Financial institutions	Product	Contravention	Year of sanction	Fine (A) (£)	Number of related consumers	Invested amount (million £) (B)	Ratio (A/B) (%)
Santander UK	structured capital at risk products	unsuitable products	2014	12,377,800	295,000	7,000	0.18
Credit Suisse International	structured deposit	misleading communication	2014	2,398,100	83,777	797	0.30

(Source: FSA/FCA final notices since 2000 related with sales of over-the-counter derivatives)

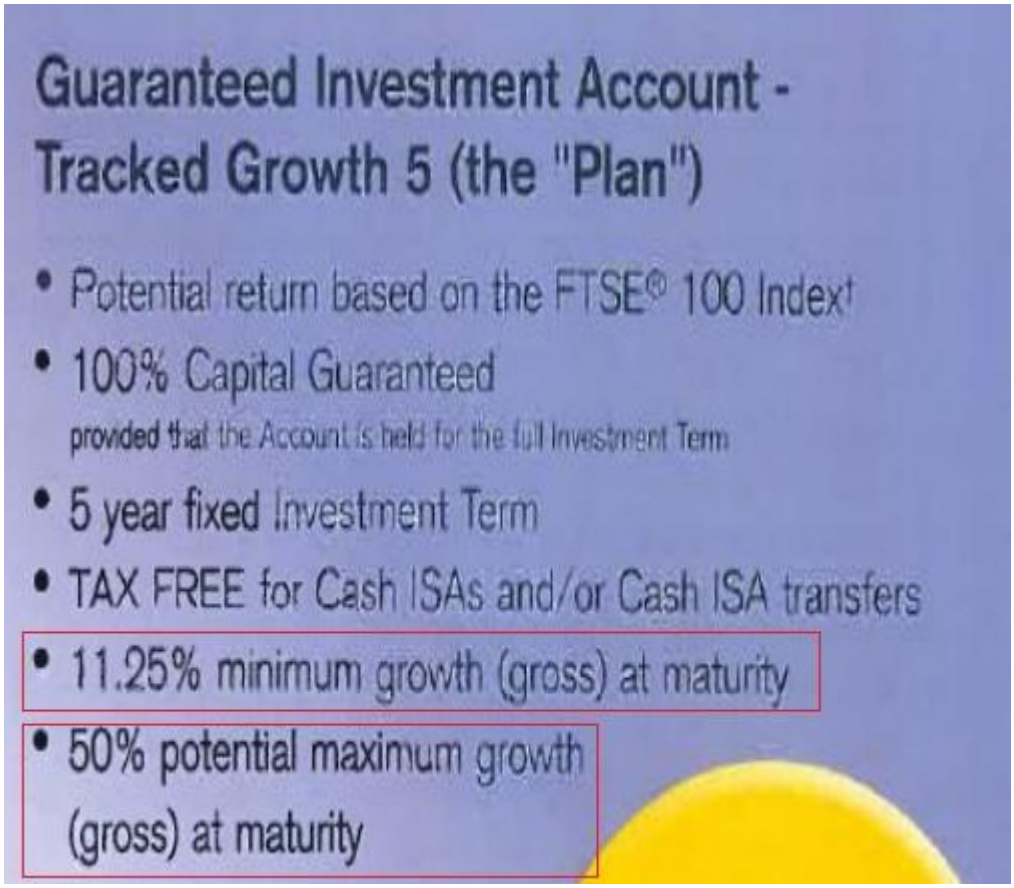
Fair, clear, and not misleading communication rule

(1) Unbalanced Prospect

All financial instrument investments—including over-the-counter derivatives—involve uncertainty about the future. Therefore, the financial institution is expected to deliver its own opinions about future market movement during the sales process. However, highlighting only the positive aspects of the prospective investment without appropriate warnings about risks is a breach of the 'fair, clear, and not misleading' communication rule.[953]

[953] Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003). In 2003, Chase de Vere Financial Solutions promoted a derivative product connected with the performance of the FTSE 100. The investor of this product was offered double the growth of the FTSE 100 and a loss when the index fell. The firm advertised this product throughout the national newspapers as 'fantastic' and 'excellent' with the warnings about the risk in fine print on another page; emphasized a rosy forecast about the equity market without a balanced warning of the risk of the downturn of the market. This advertisement was sanctioned by the FSA as a breach of 'fair, clear and not misleading' communication rule. It isn'teworthy that risk warnings in fine print on another page couldn't protect the financial institution from being sanctioned by the regulator. In fact, many researches in behavioural economics show that majority of consumers don't read fine printed disclosures in their purchases and even reading the disclosures cannot change their decision due to heuristic biases; see also Financial Conduct Authority, 'Final Notice to Santander UK plc' (24 March 2014). Santander also had a penalty imposed due to its statements of opinion stating only the up-side market direction. From 2010 to 2012, it sold investment products through its sales representative's advice, which included a structured investment with capital protection and additional returns linked to the FTSE 100. The advisers of the firm presented to consumers their personal forecast that 'the investment will likely double' and stated 'in ten years it will beat cash by 87%'. In addition, the FSA found the firm using its investment forecast tool in a misleading way: in order to make the investment look more attractive, the firm used the Bank of England's base rate which was not thought to be an actual money market return for comparison with the expected return of the investment.

Promoting a feature of an investment product that is unlikely to be realized was also considered unfair and misleading communication, although the statement was not entirely false. In 2014, Credit Suisse International ('CSI') developed a derivative product that guaranteed a minimum return, but with a cap on maximum earnings. This product was embedded with a FTSE 100-based option, and could generate additional profit if the index performed well. The product distributed by the firm through its branches and other suppliers displayed the guaranteed minimum and potential maximum returns with an equal prominence (see below).



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However, CSI's internal analysis indicated that the probability of realization of maximum return was near zero; the maximum return would not occur in the simulation based on historical data, since the FTSE 100 was launched in 1984. The FSA judged that highlighting the potential maximum return— which would realistically not be expected,

954 Financial Conduct Authority, 'FINAL NOTICE to Credit Suisse International' (2014)

even though the probability was not exactly 0%—was misleading and not fair, and imposed a financial penalty on CSI.[955]

(2) Unfair and misleading disclosure

False statements about the features of a derivative are representative examples of unfair and misleading disclosures. This malpractice is usually related to the concealment of costs, product structures, and other risky features of an investment. Chase de Vere received penalties because of advertising material asserting that there was no charge to consumers, where that was not the case. Charges would be deducted from investment returns at maturity, but was stated in fine print on a different page.[956] Santander was also sanctioned on a false statement that no commissions were charged for a structured product, when there was an actual 7.75% charge.[957] In selling IRHPs[958], banks falsely stated that the IRHP was a pre-condition of loan provision, and that banks were ultimately required to compensate consumers for detriment.[959]

No disclosure or insufficiently detailed disclosure of important aspects of a derivative product was also seen as unfair and misleading communication. Banks agreed with the regulator to compensate for the losses of a non-cap IRHP, where detailed information about the cost of non-cap products[960] were not disclosed to consumers when they didn't want to buy the cap due to its up-front premium,[961] or where early termination costs associated with the IRHP were not explained clearly.[962] Explanation of the existence of the termination cost alone couldn't protect firms. Credit Suisse International was disciplined for not providing detailed information about an early exit fee[963] even though the existence of the fee was explained.[964]

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[955] Ibid
[956] Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003)
[957] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014) 4.25-28
[958] Interest Hedging Product
[959] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (2012) annex2. 16
[960] For example, swaps or collars
[961] Ibid annex2. 25
[962] Ibid annex2. 22 (ii)
[963] It is a fee that is posed on the termination of investments before maturity.
[964] Financial Conduct Authority, 'FINAL NOTICE to Credit Suisse International' (2014) paras 5.1-5.9

Suitability rule

(1) Unsuitable advice

Recommendation of investments incompatible with the consumer's circumstances was sanctioned as unsuitable advice. In 2012, the FSA announced that Santander failed to gather sufficient and necessary client information before recommending investment products. Of the recommendations made, 42% were found to be unsuitable in suitability. Examples include recommendations of a high-risk investment by an advisor without considering the consumer's payment of credit card debt, and recommendations to a 71-year-old consumer to invest in a six-year maturity product with a high early exit fee.[965]

The regulator also viewed overly concentrated investment in a risky asset as an evidence of unsuitable advice and sanctioned Santander UK plc.[966] In addition, over-hedging IRHPs with a longer term or larger value than hedged loans were also considered unsuitable advice and non-compliant sales.[967]

(2) Failure to gather information about consumers

J.P. Morgan International Bank Limited's failure to collect consumer information before providing advice was a breach of regulation, whether or not the advice provided was

[965] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014) paras 4.31-37, 4.59~61; The firm's online tools and training programmes for the advisers were not deemed adequate for the firm to obtain sufficient and necessary information about the consumers' knowledge and experience, investment objectives, risk profiles, and the ability to bear the risk of investment.

[966] Financial Services Authority, 'FINAL NOTICE to Lloyds TSB Bank plc' (2003). Lloyds TSB Bank ("LSTB") sold from 2000 an investment product of which return was dependent on the performance of 30 shares selected from the FTSE 100. This product sought a high annual return of around 10% but would put the principal of the investment at risk when the price of selected shares fell below a certain level. The FSA found that the firm didn't consider the concentration risk in consumers' portfolio: 84% of the consumers with no experience of stock investment had invested over 20% of their total financial assets in the product; 18% of the consumers with experience of stock investment had invested over 35% of their total financial assets in the product. The FSA also recognized that the firm didn't provide any guidance on concentration risk to its sales persons. The FSA sanctioned the firm as breach of suitability rule.

[967] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (n959) annex2.30 where the regulator requested banks to demonstrate that the consumer understood the risk of over-hedging, so as to prove their legitimacy.[967]

suitable.[968] Credit Suisse UK Limited ('CSUK') was also sanctioned for its failure to gather necessary consumer information.[969]

4.1.1.2 Regulatory redress actions

In the sanctioned cases described above, the regulator has sought redress for consumers' losses from financial institutions' regulatory breach.[970] The compensations were paid not by the regulator's statutory devices[971] but through voluntary agreements with the financial institutions. Except for IRHPs compensation agreements, the contents of voluntary compensation were not publicized. Redressing consumer loss from 'mis-selling' of the IRHP is examined below.

Subject for redress

The regulator decided to redress consumers' detriment from 'mis-selling' IRHPs through 'voluntary' agreement with the relevant banks. However, the FSA limited consumers for

[968] Financial Conduct Authority, 'FINAL NOTICE to J.P. Morgan International Bank Limited' (2013). JP Morgan International Bank ("JPMIB") provided advice on investments to high-wealth individuals and some of its advice from 2010 to 2012 was reviewed by the FCA. The review revealed that in many advices given the firm didn't collect the necessary information about consumers, including financial circumstances, knowledge and experience about the investment, risk profile and ability to bear the investment risk, and so couldn't decide the suitability of the recommendation because of the lack of information of the consumers. This led to the review of the whole range of 1,416 instances of advices during this period, but only one case was detected as unsuitable because its advisers could prove the suitability of their advices through their personal memory and evidence. Even though almost all investment advices were proved to be suitable, the FCA decided on a sanction on JPMIB for breaching the Principle that a firm should organize and control its affairs with an adequate system of risk management and the rule of Senior Management Arrangement, Systems and Controls Sourcebook which requires the firm to record its business and all transactions to enable the regulator to review the firm's compliance of the regulatory requirements.

[969] CSUK sold structured capital at risk products ("SCARPs") of which return was tied with FTSE 100 or other individual equities. The FSA investigated CSUK's sales practice of SCARPs during the period from 2007 to 2009 and found the following failings: unclear risk indicators in the internal form for gathering client information; increase of some consumers' risk profiles without sufficient documentary evidence just before SCARP transactions; inconsistencies between the consumer's risk profile and investment objectives; insufficient evidence of consideration of the consumer's overall portfolio when determining whether or not the transaction was suitable; inadequate systems and controls in recommending leverage to consumers such that there was no documentation to evidence that CSUK considered whether the use of leverage was appropriate in light of the consumer's attitudes to risk and no documentation showing that the risk associated with use of leverage had been explained; inadequate systems and controls surrounding levels of investment concentration in consumers' portfolios; and failure to effectively monitor its staff to take reasonable care to make suitable advice such as the team leader who was responsible for the sales part having so many people to monitor that effective oversight was not possible.

[970] The regulator sought to redress consumers in 6 cases out of 8 sanction cases but the other 2 cases were the ones where loss didn't occur to consumers.

[971] For example, restitution orders(FSMA 2000, s 384) or consumer redress schemes(FSMA 2000, s 404)

redress to 'non-sophisticated', and didn't use the existing regulatory concepts such as 'retail client'[972] as definition, but developed a new 'sophistication test'.[973] In comparison with the 'retail client' of the COBS, the 'non-sophisticated' consumers were much more narrowly defined.[974] The consumers that were classified as 'sophisticated' by the test would have to seek compensation through litigation. According to the FSA, the sophistication test criteria came from the Companies Act 2006, which was used to determine whether a company could take advantage of the reduced reporting requirements for SMEs.[975]

This narrow definition for non-sophisticated consumers who are eligible for IRHP loss compensation triggered severe complaints and criticism.[976] It doesn't make sense to adopt a remote rule of the Companies Act for defining 'non-sophisticated' consumers, instead of the clear concept of 'retail client' in the COBS. However, a closer consideration of the regulator's powers granted by the statute shows that the narrow definition of non-sophisticated consumers seems to result from the limited enforcement options for regulatory redress.

The regulator's available tools for redress for consumers' losses are a restitution order[977], a consumer redress scheme[978], and the FOS[979]. However, in terms of IRHP 'mis-selling', the regulator practically had limited tools available. A restitution order necessitates a

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[972] FCA Handbook, COBS, 3.4.1R

[973] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' 10 available at < Interest Rate Hedging Products Pilot> accessed 9th January 2019. The sophistication test deemed as 'sophisticated' a consumer who meets at least two of the following criteria: a) an annual turnover of more than £6.5 million; b) a balance sheet total of more than £3.26 million; c) more than 50 employees. In addition, if the value of IRHP was over £10 million at the time of transaction, the consumer was deemed as sophisticated notwithstanding the result of the 'sophistication test'.

[974] COBS defines a professional client in relation to MiFID business as a company meeting two of the following criteria: a) balance sheet total of €20 million, b) net turnover of €40 million, c) own funds of €2 million (See COBS 3.5.2 (2))

[975] Financial Services Authority, 'available at < Interest Rate Hedging Products Pilot> accessed 9th January 2019

[976] See eg House of Commons Treasury Committee, 'Conduct and competition in SME lending' (2015) 40-47 available at <http://www.parliament.uk/documents/commons-committees/treasury/conduct_and_competition_in_sme_lending.pdf> accessed October 1st 2017

[977] FSMA 2000, s 384

[978] FSMA 2000, s 404

[979] FSMA 2000, s 225

court application by the regulator, which requires extensive administrative work. A restitution order by the regulator itself also requires the regulator to specify all the breaches and compensation amounts for each of the 29,568 IRHP cases, which is practically impossible.

The FOS's narrow coverage prevents its use as the major redress tool: consumers with an annual turnover of less than €2million, fewer than 10 employees, and a £150,000 award limit.[980] The most probable tool for the regulator was the FSA 2010's newly adopted 'consumer redress scheme'[981]. However, for this scheme, FSA 2010 requires that the case should appear to succeed in securing a remedy on being brought to court.[982] The majority of IRHP consumers consisted of SMEs which are not 'private persons'; the COBS cannot be applied, because only private persons have the statutory 'right of action' from regulatory breach by section 138D of FSMA 2000.[983] This implies that SMEs' IRHP cases don't seem to easily succeed in securing a remedy in court; the SMEs should rely on the common law, which considers the arm's length principle of contract more important.[984] As such, a 'consumer redress scheme' was also not available to the regulator. Without an efficient legitimate tool for redress, the regulator would not have sufficient leverage in negotiation with banks. Considering these constraints, it could be believed that the dissatisfactory coverage of eligible consumers for voluntary compensation may not come from the regulator's incapability or from surrender to the lobby of the banks.

Causation

The FSA announced that non-sophisticated consumers were to be compensated for IRHP losses caused by regulatory breaches.[985] However, non-compliant sales would not be compensated for when it was reasonable that the consumer would have followed the

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[980] Financial Conduct Authority, *FCA Handbook*, Glossary Definition micro-enterprise; Financial Ombudsman Service, 'The Ombudsman and Smaller Businesses' (2014)

[981] See p 8 5

[982] FSMA 2000 s.404 (b); see n490

[983] Financial Services Authority, 'Guidance note Consumer Redress Scheme' (2010) 10.2

[984] See section 5.1

[985] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' 9 available at <https://www.fca.org.uk/consumers/interest-rate-hedging-products> accessed 9th January 2018

same course of action, notwithstanding the breach[986]—indicating that the regulator considered causation an important factor in redressing consumers' losses. The characteristics of the regulator's causation test are explained below.

The causation test starts with the usual private law question, namely, 'would the consumer have taken the same course of action but for the firm's breach?'[987] For example, if a consumer was misled into buying the IRHP through the false explanation of it being a mandatory condition for loan provision, the test would answer 'no' and the bank would have to compensate all the losses.[988]

A difficult situation is when a consumer, who made an 'express wish'[989] to hedge the interest rate risk, had not been told by the bank about the IRHP's risk or the significant termination cost. The regulator set out the answer to this question based on its own expectation of the consumer's reasonable reaction. It assumed and required the bank to assume that the consumer would have selected a simpler IRHP product, such as a cap or a plain swap, with the termination cost of less than 7.5% of the nominal amount of the IRHP. The bank had to compensate to the consumer for the difference between the purchased product and the simpler IRHP, embedded with a 7.5% termination cost.[990] A characteristic of the above causation test is the regulator's assumption of its own prospective result (7.5% break cost and a simple product), instead of merely adopting the 'but for' test.

4.1.2 Approach by the UK regulator to enforcement

The previous section has analysed the disciplinary and redress actions of the UK regulator against 'mis-selling' of over-the-counter derivatives. The analysis of the sanctioned cases provides a snapshot of the approach that the regulator adopts to

[986] Ibid
[987] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' 10 <https://www.fca.org.uk/consumers/interest-rate-hedging-products> accessed 9th January 2018
[988] Ibid 16
[989] Ibid 48-51
[990] Ibid

intervene into failures of financial institutions. This section examines the regulator's approach to its intervention.

Focused on group failures

A characteristic of the UK regulator's disciplinary actions related to 'mis-selling' of over-the-counter derivatives is the use of its powers on large-scale cases. Each of the eight disciplinary actions by the regulator since 2000 involved at least 259 consumers[991], with a maximum of 295,000 consumers[992] (see the Table 1). The investments related to each case ranged from £720 million[993] to £7 billion[994]. This focus on large-scale cases can be viewed as the regulator's pursuit for maxim efficiency of resource use. It can be associated with the pre-crisis reactive enforcement approach[995], under which the regulator directly intervened only with the evidence of wrongdoing. FSMA 2000 also requires the regulator to 'use its resources in the most efficient and economical way' as one of its regulatory principles.[996]

Financial penalty as a major coercive tool

The regulator has various coercive tools[997] for enforcement. Table 1 indicates the use of financial penalties as its major regulatory tool. However, the effectiveness of financial penalty as deterrent raises a question. Table 1 shows the financial penalty imposed on financial institutions that 'mis-sold' over-the-counter derivatives, ranging from 0.06% to 0.54% of the volume sold. Even though financial institutions' exact margin cannot be obtained, a fine of below 1% of the transacted volume would be less than the commission earned through the penalized behaviour.[998]

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[991] Financial Services Authority, 'Final Notice to Chase de Vere Financial Solutions plc' (2003)
[992] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014)
[993] Financial Services Authority, 'Final Notice to Lloyds TSB Bank plc' (2003)
[994] Financial Conduct Authority, 'Final Notice to Santander UK plc' (2014)
[995] See n1032
[996] FSMA 2000, s.3B (1) (a)
[997] They include public censure, financial penalties, suspending permission, restitution orders, and cancelling permission
[998] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167. The bank sold interest rate swap worth £2 million and earned £89,500 (4.48%) as commission without disclosure.

The insufficient deterrent effect of imposed fines had led the regulator to adopt a new framework for calculation of fines in 2009.[999] However, Table 1 shows that the new framework may still not be sufficient for full deterrence. This can partly be attributed to various 'mitigating factors' [1000] and 'settlement discounts' [1001] when determining the financial penalty, even though those discounting factors are believed to be necessary in facilitating cooperation from penalized financial institutions during the investigation process. In seven out of eight sanctioned cases,[1002] the penalized firm received a 30% fine reduction, based on the 'settlement discount'. Sanctions by the regulator also cause reputational loss to the penalized firms. However, reputational loss may not be substantial enough for salespersons who pursue their personal interest, and even for management, who are more attracted to short-term performance.[1003]

Voluntary compensation scheme

Disciplinary actions and redress are both important for the regulator to meet 'the consumer protection objective'. Disciplinary actions deter similar future undesirable behaviours. Redress could be the imminent method of protecting consumers by providing compensation for the losses incurred. Considering the burdensome expenses of the litigation for redress[1004], the regulator's action for compensation has an important meaning to affected consumers. FSMA 2000 provided the regulator with the power to seek redress for consumer losses through 'restitution order', which can be executed by the court[1005] or the regulator itself,[1006] or through 'consumer redress schemes'[1007].

However, the regulator has never used this official redress power in the 'mis-selling' cases of over-the-counter derivatives; instead, they depended on the penalized financial institutions' 'voluntary compensation' agreement, which means that the firms in

[999] Financial Services Authority, 'FSA proposes bigger fines to achieve credible deterrence' (2009) <http://www.fsac.org.uk/library/communication/pr/2009/091.html> accessed 17 February 2016
[1000] Financial Conduct Authority, *FCA Handbook*, DEPP 6.5A.3
[1001] Financial Conduct Authority, *FCA Handbook*, DEPP 6.5A.5
[1002] The exception was the Santander 2012 sanction case.
[1003] Alessio M. Pacces (n402) 484
[1004] See House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 163
[1005] FSMA 2000, s 382
[1006] FSMA 2000, s 384
[1007] FSMA 2000, s 404

contravention of regulatory duties agreed to compensate consumers' losses on their own. This unofficial measure could be adopted for its swift and less complicated procedures.[1008]

The voluntary compensation scheme is admittedly a pragmatic method to relieve consumers' detriment in a swift and economic way. However, before the IRHP scandals, regulators' processes lacked transparency. In all the voluntary compensation cases of 'mis-selling' of over-the-counter derivatives, the final notice by the regulator contained only short comments stating that the sanctioned financial institutions agreed to compensate consumers for losses. No information about the voluntary compensation criteria was publicized, such as the criteria for eligibility and calculation of compensation.[1009]

Recently, the opaqueness of voluntary compensation agreements became a contested social and political issue. With parliament's continuous critics[1010], and consumers' structured resistance[1011], the FCA had to publicize the contents of voluntary compensation agreements with banks regarding the IRHPs.[1012]

Information on the detailed criteria of voluntary compensation should continue to be publicized 'voluntarily' in future for other 'mis-selling' cases. Without information on compensation criteria, the consumer who claims 'mis-selling'-related losses cannot determine whether he has been compensated fairly, and has no choice but to accept the

[1008] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 37; The chairman of FCA explained the rational of voluntary compensation in dealing with the IRHP 'mis-selling' scandal: 'I think that if we, as a regulator, are to do mass redress schemes, of which this is classically one, we have two ways of doing it. Either we go through the law courts, which takes a very great length of time and costs a very great deal of money, or, as a proactive regulator, we go out on the front foot and say, "This is how we are going to do it", and the necessary part of "this is how we are going to do it" is coming to an arrangement with the banks that is "voluntary", or at least contractually voluntary, to do it that way. If they refuse, we end up in the law court and we get into a PPI-type situation.'

[1009] The opaqueness of voluntary compensation is also in other financial services areas than over-the-counter derivatives. See Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) n92

[1010] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 47

[1011] See eg Bully-Banks was created in December 2011 by business owners each of whom had been mis-sold Interest Rate Hedging Products. <http://www.bully-banks.co.uk/site/> accessed 15 May 2015

[1012] Financial Services Authority, 'INTEREST RATE HEDGEING PRODUCT REVIEW' (A letter to relevant banks) (n959)

firm's compensation offer. This could lead to another failure of consumer protection. With adequate information, consumers could monitor the financial institution's compensation.

4.1.3 Enforcement strategy of the UK regulator

The UK financial regulator's enforcement strategy can be summarised in one word: outcome-oriented, which is a continuation of pragmatism[1013] in standard-setting. These two concepts imply that the overall financial regulation process is focused on achievement of the policy goal. Generally speaking, an outcome-oriented approach to enforcement is flexible in exercising power and responsive to the current situation and changes. [1014] In order to achieve the regulatory outcome, the performance of the current enforcement strategy is analysed and responsively adjusted.[1015]

Outcome-oriented enforcement in the UK is similar to what Baldwin and Black suggested as the 'really responsive regulation'. According to their explanation, the regulator should be responsive not only the compliance performance of a certain regulatee,[1016] but also the attitudinal settings of the community of regulatees, the broader institutional environment of the regulatory regime, the regime's own performance, and changes in each of the above elements.[1017]

The enforcement strategy of UK financial regulation is an on-going journey towards the optimal enforcement method, even though it may be an impossible mission. On this journey, the UK has been assessing the performance of the current enforcement strategy,

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[1013] See section 3.4.1

[1014] Neal Shover et al, 'Regional Variation in Regulatory Law Enforcement' in Keith Hawkins and John M. Thomas, *Enforcing Regulation, (*Springer, 1984) 123

[1015] Financial Conduct Authority, 'Business Plan 2013/2014' (2013) 4-6; the CEO of the FSA said that: '[o]ur culture should reflect the world around us and change in response to it. A major risk for any regulator is a natural tendency to become bound, often unconsciously, to the conventional thinking and approaches of the day. We need to build a new regulatory culture that stresses openness − and therefore predictability − by learning from our own experience and from others. We need to make it natural to question ourselves so that we avoid 'group think' and are continually looking to explore new approaches and perspectives, be it from our staff, other regulators and the world at large.'

[1016] Ian Ayres and John Braithwaite, *Responsive regulation: Transcending the deregulation debate* (n945) 35-44

[1017] Robert Baldwin and Julia Black, 'Really Responsive Regulation' (2008) 71 *Mod. L. Rew.* 59, 91-93

and has been finding new strategies to address the identified defects.[1018] The following text discusses how the UK regulator's enforcement strategy has changed since the launch of the single regulator.

Light touch

Regulatory enforcement action can be divided into compliance-related activity to facilitate the regulated's compliance and sanction-related activity to penalise those who contravene the regulation. [1019] 'PBR', which was explicitly declared by the FSA, basically embraced a compliance-focused enforcement strategy.[1020] It encompasses the strategy for standard-setting as well as enforcement. In the dimension of standard-setting, 'PBR' means moving from detailed and prescriptive rules to general standard rules containing regulatory goals. In the dimension of enforcement, [1021] it means that the overall objective of the regulator is to help the regulated make their own decisions about appropriate processes and controls for meeting the principles. [1022] Under 'PBR', financial institutions' senior management is responsible for implementation of regulatory obligations, and the regulator's role is to enable compliance of the regulated with the general standard rules.[1023] Thus, the enforcement of 'PBR' was based on a compliance-focused approach.

This approach is an enforcement strategy with a major goal of supporting compliance of the regulated with the standard rules rather than detecting and sanctioning the breach

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[1018] For example, see Julia Black, 'The development of risk-based regulation in financial services: just 'modelling through?' in Julia Black, Martin Lodge and Mark Thatcher, *Regulatory Innovation: A Comparative Analysis* (Edward Elgar Publishing Limited, 2005); see also Iain MacNeil, 'The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?' [2007] 2.4 *Capital Market Law Journal* 345

[1019] Keith Hawkins, 'Bargain and Bluff: Compliance Strategy and Deterrence in the Enforcement of Regulation' [1983] 5 *Law and Policy Quarterly 35*; See also Keith Hawkins and John M. Thomas, 'The Enforcement Process in Regulatory Bureaucracy' (n798) 13-15; see also Salo Coslovsky et al, 'The Pragmatic Politics of Regulatory Enforcement' (n824) 324-325

[1020] Financial Services Authority, 'Principle-based regulation: Focusing on the outcomes that matter' (n820) 2; compliance-focused enforcement isn't only found in the financial services industry but all other business sectors in the UK; for example, see David Vogel, *National Styles of Regulation (*Cornel University Press, 1986) 19-30 and 269

[1021] Financial Services Authority, 'Principle-based regulation: Focusing on the outcomes that matter' (n820) 4-5

[1022] Ibid 11

[1023] Ibid 7, 14

of standards.[1024] Compliance-focused enforcement aims to prevent potential breach of regulatory standards rather than to detect breach.[1025]

Compliance-focused enforcement by the UK regulator is best represented by 'Guidance' in the rulebook. The Guidance helps to clarify the vague rules of 'principle-based' standards and is a tool to support compliance.[1026] Non- compliance with the 'Guidance' of the FCA Handbook isn't a breach of Rules and not a subject of disciplinary action, but compliance is intended to be the same as compliance with the related Rules.[1027] In other words, the guidance is a device for assisting the regulated to comply, and not a device for defining and detecting wrongdoing.

In addition to the Guidance of the regulator's rulebook, the UK regulator gave 'Guidance status' to many other resources.[1028] In addition, the FSMA 2000 enabled the FSA to provide specific individual guidance to regulated financial institutions. Such individual guidance—that is, regulatory advice for a specific situation of a particular financial institution— differed from the guidance of the FSA Handbook, which is aimed at the wider regulated population. If individual guidance is complied with, the related rules are assumed to have been complied with, and hence doesn't become subject to disciplinary action, having the effect of a 'no action letter'.[1029] In order to help the regulated comply with the regulatory requirements, the UK regulator published various resources[1030] on specific regulatory topics. For example, the FSA published dozens of documents explaining the regulatory requirements of 'suitability'.[1031]

[1024] Albert J. Reiss, 'Selecting Strategies of Social Control over Organizational Life' (n929) 23

[1025] Ibid

[1026] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 20

[1027] See section 4.1.1.2

[1028] Ibid

[1029] See https://www.sec.gov/fast-answers/answersnoactionhtm.html accessed 29th April 2017

[1030] They include 'policy statements', 'consultation papers', and 'discussion papers'; see <https://www.fca.org.uk/publications/search-results?np_category=policy%20and%20guidance-policy%20statements&start=1> accessed 29th April 2017; for the explanation of publicized materials, see also Simon Morris, *Financial Services Regulation in Practice* (Oxford University Press, 2016) para 7.08

[1031] For example, see <http://www.fsa.gov.uk/portal/site/fsa/fsa-google-search-result?cx=007702012814746907219%3Avvguzpuphuq&cof=FORID%3A9&ie=UTF-8&q=suitability&globalsearchsubmit=Search&siteurl=www.fsa.gov.uk%2Flibrary&ref=www.fsa.gov.uk%2F&ss=1825j1023519j11&siteurl=www.fsa.gov.uk%2F> and < https://www.fca.org.uk/search-results?search_term=suitability> accessed 29th April 2017; see also FSA, 'Financial guidance: Assessing

In disciplinary actions against breach of rules, the enforcement of 'PBR' adopted evidence-based enforcement, which means that the regulator didn't intervene directly until 'something went wrong'.[1032] This reactive enforcement style was referred to as 'light-touch'.[1033] Out of the eight sanctioned cases of 'mis-selling' of over-the-counter derivatives after the year 2000, only two resulted in disciplinary actions during the 2000-2007 period during which the light-touch approach was applied, reflecting its reactive approach.[1034]

The 'light-touch' approach of the FSA was a tactic for attracting global firms and investors in the competition between London and New York for global financial centres,[1035] based on the belief that firms and investors seeking access to the global financial market would favour the financial centre with the least regulatory intervention.[1036] The approach resulted from social and political demands on the regulator, rather than being the regulator's own decision,[1037] as Lord Turner evidenced in parliament in 2009.[1038]

Suitability'; see also FSA, 'FS07/1: Suitability Standards for advice on Personal Pension' (2007); see also FSA, 'Investment advice and platforms thematic review' (2010)

[1032] Financial Services Authority, 'Business Plan 2010/11' (2010) 9-10; see also Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action': A Challenge for the EU' in Klaus J. Hopt, *Financial Regulation and Supervision: A post-crisis analysis* (Oxford University Press, 2012) 87

[1033] Julia Black, 'Regulatory Styles and Supervisory Strategies' (n819) 229-230

[1034] Table 1 at p１６３; for the empirical study of enforcement of the UK, see John C. Coffee, 'Law and the market: The impact of enforcement' 156.2 [2007] *University of Pennsylvania Law Review* 229; see also Iain MacNeil, 'The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?' (n1018) 345

[1035] See, for example, M Cole, Director of Enforcement, 'FSA, The UK FSA: Nobody Does it Better' (2006) speech at Fordham Law School, New York, 17 October 2006, 270-271 <www.

fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017_mc. 노스|> accessed 1st May 2017

[1036] Ibid 271-272; in the contrary see Bruce G. Carruthers and Naomi R. Lamoreaux, 'Regulatory Races: The Effects of Jurisdictional Competition on Regulatory Standards' (2016) 54.1 *Journal of Economic Literature*, 52, 87-90, where the authors argued that there was no empirical evidence found proving that regulatory 'races to the bottom' did occur in the reality; see also Robert Baldwin, Martin Cave, and Martin Lodge, 'The Future of Regulation' in Robert Baldwin, Martin Cave, and Martin Lodge, *The Oxford handbook of regulation* (Oxford University Press, 2010) 613

[1037] Norman S. Pose, 'WHY THE SEC FAILED: REGULATORS AGAINST REGULATION' (2009) 3 *Brook. J. Corp. Fin. & Com. L*, 289, 317-319, where the author found the social demand of reactive and minimum regulatory intervention in the US, as well.

[1038] Treasury Select Committee, 'Minutes of Evidence Taken Before Treasury Committe' on 25th February 2009' Available at
<https://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/uc144_ix/uc14402.htm>

Black argued that an inherent drawback of the reactive enforcement strategy was that case-by-case enforcement created an 'intelligence gap' about patterns and causes of illegal behaviours.[1039] More importantly, the general public's trust in the financial services industry was weakened by a series of large scandals, even though discipline and victim rewards were associated with each case.[1040] Deterrence in the financial services industry is associated with the general public's trust in the market, and the cost of deterrence failure is substantial.[1041]

Credible deterrence

The FSA's 'light-touch' approach to enforcement was abandoned after the global financial crisis.[1042] In the dimension of prudential regulation, the failure of Northern Rock revealed a critical drawback of the reactive intervention of the 'light-touch' approach, which proved to be inappropriate for catastrophic risks.[1043] In the dimension of COB, the

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accessed 5th May 2017; in the committee Lord Turner said that 'I think it is also the case that that existed within a political philosophy where all the pressure on the FSA was not to say: "Are you looking more closely at these business models?" but to say: "Why are you being so heavy and intrusive? Can you not make your regulation a bit more light touch?'

[1039] Donald J. Black, 'The mobilization of law' (1973) 2.1 *The Journal of Legal Studies*, 125, 134-135; see also Julia Black, 'Restructuring Global and EU Financial Regulation: Character, Capacity, and Learning' in Klaus J. Hopt, *Financial Regulation and Supervision: A post-crisis analysis* (Oxford University Press, 2011) 41, where she explained that the regulator was like a drunkard 'who only searches for his lost wallet under a street lamp because that is where the light is.'

[1040] Mark Carney, Governor of Bank of Canada and Chairman of Financial Stability Board, 'Rebuilding Trust in Global Banking', speech at Western University , London, Ontario on 25th February 2013 at < http://www.bis.org/review/r130226c.pd> accessed 29th May 2017; see also Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance 'mis-selling' Scandal in the UK' (n1040) 247; for the general weaknesses of reactive enforcement, see Malcom K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance (*Brooking Institution Press, 2011) location 2254-2394 (kindle edition)

[1041] Katharina Pistor and Chenggang Xu, 'Law enforcement under incomplete law: Theory and evidence from financial market regulation' (n796); see also Stephen Lumpkin, 'Consumer protection and financial innovation' (2010) 1 *OECD Journal*, 117, 121-127; see also Folarin Akinbami, 'Financial services and consumer protection after the crisis' [2011] 29.2 *International Journal of Bank Marketing*, 134; see also Peter D. Spencer, *The Structure and Regulation of Financial Market (*Oxford University Press, 2000) location 478-518 (kindle edition); see also Roman Tomasic and Floran Akinbami, 'The role of trust in maintaining the resilience of financial markets' (2011) 11.2 *Journal of Corporate Law Studies* 369, 377-386; see also Brigitta Lurger 'Old and New Insights of the Protection of Consumer Protection' in Roger Brownsword *et al*, *The Foundations of European Private Law (*Hart Publishing, 2011) 104

[1042] Financial Services Authority, 'Turner Review: A Regulatory Response to the Global Banking Crisis' (2009) 86-89; see also Eric J. Pan, 'Four Challenges to Financial Regulatory Reform' (2010) 55 Vill. L. Rev. 743, 743-746

[1043] Robert Baldwin and Julia Black, 'Really responsive regulation' (n1017) 62-63

LIBOR scandal, which occurred during the turmoil of the crisis, was the final setback to the 'light-touch' approach.[1044] The key trader in the scandal said in the investigation that 'I didn't think about innocence or guilt.'[1045] It revealed not only the immorality of some traders, but also the overall lack of ethics of the City.

The 'light-touch' approach, with minimal direct intervention, was based on the assumption that the regulated had goodwill to comply with regulatory obligations, and that contravention was usually due to insufficient understanding of the obligations.[1046] However, the LIBOR scandal proved this assumption wrong. Even before the scandal took place, the superficial ethics of the financial services industry was already apparent from the continuous occurrence of 'mis-selling' scandals.

The FSA announced a change from the 'light-touch' approach to proactive intervention.[1047] For proactive prevention, it conducted intensive supervision to form its own view of the business models and risks of each financial institution.[1048] Supervision included mystery shopping and on-site visits to financial institutions to identify issues before they became public.[1049] It was supported by the 'credible deterrence' strategy of taking a strong enforcement stance on identified wrongdoing in order to change behaviour.[1050] The 'credible deterrence' approach included an increase in the magnitude of fines for breach of rules.[1051]

However, the FSA's intensive supervision and credible deterrence approach didn't resort to 'command and control style' rule-based detection and sanction.[1052] Instead, the

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[1044] Tracey McDermott, Director of Enforcement and Financial Crime, the FCA, 'Enforcement and Credible Deterrence in the FCA' at the Thompson Reuters Compliance & Risk Summit, London 18 June 2013 (2013) 3

[1045] Daniel Fitzpatrick, *The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 66

[1046] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984)

[1047] Financial Services Authority, 'Business Plan 2010/11' (n1032) 10; see also Niamh Moloney, 'The European Securities and Markets Authority and institutional design for the EU financial market – a tale of two competences: Part (2) rules in action' (2011) 12.02 European business organization law review, 177, 187-190

[1048] Ibid 10

[1049] Ibid

[1050] Ibid 11

[1051] Financial Supervisory Authority, 'FSA proposes bigger fines to achieve credible deterrence' (2009) available at <http://www.fsac.org.uk/library/communication/pr/2009/091.html> accessed 17 February 2016

[1052] The UK financial regulatory regime was exceptional because many jurisdictions went back to command and control style regulation after suffering large regulatory failures. See Richard Rawlings 'Introduction:

regulator used the high-level principle in its rulebook as the key reference for disciplinary actions.[1053] The FSA explicitly announced that the 'credible deterrence' enforcement philosophy was to 'ensure that firms adhere to the FSA's principles'.[1054]

TCF initiative

With the continuous occurrence of 'mis-selling' scandals,[1055] the FSA realized the limitations of 'PBR', and the strategy of 'light-touch' enforcement of general standard rules.[1056] In response, the FSA launched the Treating Customers Fairly (TCF) initiative in 2004. This initiative was experimental, and tried to disrupt the chronic cycle of 'mis-selling', loss, enforcement, redress, and reform.[1057] The TCF initiative didn't invent new rules, but presented six outcomes for financial institutions to achieve; these overlapped with the FSA Handbook's existing principles. Instead of resorting to more stringent enforcement of the related rules, it targeted the regulated's culture change—thus adopting a more compliance-focused 'principle-based' approach.[1058]

The TCF initiative's compliance-supportive approach firstly committed regulatory attention to dealing with individual financial institutions via direct and informal communications.[1059] Whereas the FSA Handbook addressed general advice for the whole

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Testing Times' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications (*Oxford University Press, 2010) 20

[1053] Gilad found that the ratio of the regulator's enforcement, based on Principle 6—namely, 'duty to treat customers fairly'— was 0% in 2002, 10% in 2003, 13% in 2004, 20% in 2005, 58% in 2006, and 67% in 2007; see Sharon Gilad, 'Institutionalizing fairness in financial markets: Mission impossible?' (2011) 5.3 *Regulation & Governance* 309, 317

[1054] Financial Services Authority, 'A regulatory response to the global banking crisis' (Discussion paper 09/2, 2009) para 1.67

[1055] Sharon Gilad, 'Institutionalizing fairness in financial markets: Mission impossible?' (n1053) 313 where he explained that an average 3 million consumer complaints about 'mis-selling' were submitted to the regulator; see also Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) 220

[1056] Andromachi Georgosouli, 'The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work' (2011) 38.3 *Journal of Law and Society*, 405, 417-418

[1057] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) 220

[1058] Andromachi Georgosouli, 'The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work' (n1056) 405, 417; see also Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 20-21

[1059] Andromachi Georgosouli, 'The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work' (n1056) 417-418

community of the regulated, the UK regulator provided individual guidance for certain financial institutions to help them achieve the TCF initiative's six outcomes.[1060]

Second, the TCF initiative was implemented in internal business processes through participation of individual financial institutions. Implementation involved senior management, because they were thought to be in a better position to know how to structure internal processes to achieve the outcomes.[1061] The TCF initiative allowed financial institutions flexibility on how to reach the six outcomes,[1062] but required evidence that their internal processes fulfilled the initiative's requirements, providing forward-looking support for compliance instead of backward-looking breach detection.

In summary, the TCF initiative required financial institutions to evaluate their internal processes, governance, and control in light of the six outcomes of 'treating customers fairly'.[1063] The initiative aimed to change the overall practice in the financial services industry by stimulating self-regulation.

The TCF initiative's individual institution-focused, participation-based, and process-oriented approach demanded extensive resources from the regulator.[1064] It was one of the core focal points of the regulatory agenda for a couple of years since 2004. However, the TCF initiative seems to have failed to achieve the intended outcomes,[1065] even though it was an innovative enforcement approach based on 'law in action' and not on 'law in the book'.[1066] Large scale 'mis-selling' of IRHPs and payment protection insurance

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[1060] Ibid

[1061] Hector Sants, 'The FSA Retail Agenda: Working with the Industry' speech by CEO of the FSA at the Association of Private Client Investment Managers and Stockbrokers conference, 21 November 2007

[1062] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 21

[1063] Andromachi Georgosouli, 'The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work' (n1056) 416; Folarin Akinbami, 'Financial services and consumer protection after the crisis' (2011) 29.2 *International Journal of Bank Marketing* 134, 149-150

[1064] Justin O'Brien and George Gilligan, *Integrity, Risk and Accountability in Capital Markets: Regulating Culture (*Bloomsbury Publishing, 2015) location 2864 (kindle edition)

[1065] Sharon Gilad, 'Institutionalizing fairness in financial markets: Mission impossible?' (n1053) 323; see also Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance 'mis-selling' Scandal in the UK' (n1040) 265; see also Rahul Odera, 'Shadow minister: TCF has failed' (2012) available < http://www.professionaladviser.com/ifaonline/news/2156713/shadow-minister-tcf-failed> accessed 2nd May 2017;

[1066] Niamh Moloney, 'Regulating the Retail Market' (n739) 758-759

was occurring during implementation of the TCF.[1067] The regulator itself acknowledged that the TCF initiative had limitations.[1068]

After the crisis, the FSA decided to convert some TCF guidance to rules in the FSA Handbook, [1069] which could be seen as a confession of the initiative's failure. Gilad argued that it was a fundamental misunderstanding of culture to suggest that a regulatory initiative and implementation of a compliance system could lead a hierarchical organization to compliant behaviour.[1070]

Reforming the culture

After the LIBOR manipulation scandal, UK policy makers started to realise that credible deterrence and TCF would not be sufficient to prevent another scandal of such magnitude. As the first step, fine amounts were raised under the credible deterrence approach; however, a limitation was that financial institutions could see the fine as a

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[1067] Financial Services Authority, 'Payment Protection Insurance: A Thematic Update' (2008) available at <www.fsa.gov.uk/library/other_publications/miscellaneous/2008/ppi_update.스|> accessed 6th October 2017; see also Financial Services Authority, 'FSA, Interest Rate Hedging Products: Pilot Findings' (2013) available at <www.fsa.gov.uk/pubs/other/interest-rate-swaps-2013.pdf> 6th October 2017

[1068] Financial Services Authority, 'Business Plan 2010/11' (n1032) 10; it said that "It therefore, in practice, remained essentially a reactive strategy from our perspective. That said, the TCF initiative has yielded some important benefits particularly with regard to raising management awareness of the outcomes the FSA seeks and the culture TCF is meant to foster. But it has not yet delivered substantial on the ground benefits to consumers."

[1069] Financial Services Authority, 'Product Intervention: DP11/1 (2011) 45–46 available at <www.fsa.gov.uk/pubs/discussion/dp11_01.pdf>; see also Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance 'mis-selling' Scandal in the UK' (n1040) 259

[1070] Christine Parker and Sharon Gilad, 'Internal corporate compliance management systems' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 177; see Sharon Gilad, 'Beyond Endogeneity: How Firms and Regulators Co-Construct the Meaning of Regulation' [2014] 36.2 *LAW & POLICY*, 134. According to Gilad, no empirical evidence can be found to support the success of the TCF initiative and she presented some reasons for the failure. First, she argued, the outcome-focused initiative became 'managerialized' as it became implemented in financial institutions. Instead of a project that achieves the outcomes of the initiative, it turned into managerial project of the regulated for showing evidence that the outcomes were being achieved. Secondly, financial institutions couldn't recognise that there was a gap between the existing selling practice and regulatory obligation. The first response shown by many management of financial institutions to the TCF initiative was that '[T]he TCF initiative was already integrated into our programme'. According to Gilad, there was misalignment between the regulator and the regulated on the basic understanding about the TCF initiative. For example, with respect to the outcomes which the TCF pursued, the focus of the employees of the financial institutions was to sell products with high consumer satisfaction, whereas the regulator's focus was on selling products that are suitable or appropriate for the consumer, apart from the consumer satisfaction. This lack of recognition of the existing gap between the internal norm and resulted in relatively limited changes to the internal processes and culture of the financial institutions.

mere business cost, in which case the increase would not be effective in deterring wrongdoing.[1071] The failure of the TCF initiative showed that the enforcement approach of relying only on the internal control system of the regulated also needs review. The TCF initiative had been based on the trust that the regulated, particularly the management of the financial institutions, would improve their internal business process based on 'basic moral norms'.[1072]

As the limited effect of increased penalties and business process rebuilding became evident, the focus of policy makers shifted to the defected culture of the financial services industry.[1073]

Culture review

[1071] Justin O'Brien, 'On culture, ethics, and the extending perimeter of financial regulation' in Nicholas Dorn, *Controlling Capital: Public and Private Regulation of Financial Market (*Routledge, 2016) 22; see also p 173; See Parliamentary Commission on Banking Standards, 'Changing Banking For Good: First Report of Session 2013-14, Volume II (HL Paper 27-II, HM Stationery Office, 2013) p306, available at <http:// www.parliament.uk/ documents/ banking-commission/ Banking-final-report-vol-ii.pdf> accessed 11th May 2017; see also Pat O'Malley, *The Currency of Justice (*Routledge-Cavendish, 2009) 80

[1072] Andromachi Georgosouli, 'The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work' (n1056) 412; see also Justin O'Brien and George Gilligan, *Integrity, Risk and Accountability in Capital Markets: Regulating Culture (*n1064) location 2899-2933; O'Brien used the case of 'mis-selling' of payment protection insurance to explain why the TCF initiative failed. He pointed out that, as part of the TCF initiative, the regulator had kept warning financial institutions that the commission-based remuneration system could cause sales representatives to mis-sell financial instruments and so the management of financial institutions couldn't fail to realize that they were acting contrary to the TCF initiative. He summed up that the TCF initiative succeeded in educating what 'treating customers fairly' meant but it failed to prevent the regulated from doing business in a way that was not TCF, and concluded that 'far from TCF altering culture, culture may well have defeated TCF.

[1073] Hector Sants, Chief Executive of the FSA, 'Can culture be regulated?', speech at Mansion House Conference on Values and Trust on 04 October 2010, available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1004_hs.shtml> accessed 11th May 2017; he argued that: 'we must address the role that culture and ethics play in shaping these. I believe that until this issue is addressed we will not be able to prevent another crisis of this magnitude from occurring again, and will never fully restore the trust of society in the financial system.'; see John Kay, 'The Kay review of UK equity markets and long-term decision making. Final Report' *(*2012) available at <http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf> accessed 25th May 2016; Professor Kay also suggested in his final report to Department for Business, Innovation and Skills that '[T]he present situation is a product of the trading culture in which both companies and their shareholders operate, and the best route to reform is to change that culture.'; see Parliamentary Commission on Banking Standards, 'Changing Banking For Good: First Report of Session 2013-14, Volume II (HL Paper 27-II, HM Stationery Office, 2013) 306, available at <http:// www.parliament.uk/ documents/ banking-commission/ Banking-final-report-vol-ii.pdf> accessed 11th May 2017; Parliamentary Commission on Banking Standards commented "is a long way from being an industry where professional duties to customers, and to the integrity of the profession as a whole, trump an individual's own behavioural incentives."

In response to growing social demand for an overhaul of the financial services industry's culture, the regulator's approach toward 'culture change' refocused from cautious and indirect intervention to proactive and direct intervention. In 2013, the FCA's director of supervision said that '[o]ur approach today is… joining the dots rather than assessing culture directly.'[1074] His remark indicated that the regulator was concerned about culture, but didn't intend to define the 'right culture' in detail.[1075] However, the FCA announced in its 2015/2016 business plan that it would conduct a thematic review of the culture of each individual financial institution, and commenced the review of selected institutions.[1076] It showed a significant change in the regulator's attitude towards the goal of enhancing the culture of the financial services industry, from cautious and indirect intervention to proactive and direct intervention.

The thematic review focused on issues of financial incentives, appraisal, and promotional decisions of middle managers and how whistleblowing was dealt with.[1077] The thematic review implied that the regulator would suggest the 'right' culture, or at least find the 'wrong' culture, in each individual financial institution. The British Banker's Association, in its response to the thematic review, warned that 'banks in the UK should face internal consequences for failing to tackle the lack of diversity.'[1078]

This bold project to investigate and improve the culture of an individual financial institution was suddenly abandoned, following the unexpected departure of the CEO of

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[1074] Clive Adamson, Director of Supervision of the FCA, speech at the CFA Society on 19th April 2013 available at < https://www.fca.org.uk/news/speeches/importance-culture-driving-behaviours-firms-and-how-fca-will-assess> accessed 25th May 2017

[1075] Patrick John Ring, Cormac Bryce, Ricky McKinney and Rob Webb, 'Taking notice of risk culture –the regulator's approach' (2016) 19.3 *Journal of Risk Research*, 364, 382

[1076] Financial Conduct Authority, 'Business Plan 2015/2016' (2015) 42 available at <https://www.fca.org.uk/publications/corporate-documents/our-business-plan-2015-16> accessed 11th May 2017

[1077] Financial Conduct Authority, 'Culture in banking' (2015) 1 available at <https://www.fca.org.uk/publication/foi/foi4350-information-provided.pdf> accessed 12th May 2017

[1078] Emma Dunkley, 'UK draws line under 'banker bashing' after scrapping assessment' (Financial Times, 30 December 2015) available at <https://www.ft.com/content/e926e9e2-aef1-11e5-993b-c425a3d2b65a> accessed 1st May 2017

the FCA, who initiated this project enthusiastically.[1079] The regulator's rationale[1080] for shelving the thematic review seems almost the same as the British Banker's Association's warning[1081] about the financial industry's losing of cultural diversity.[1082] As a result, the new attempt to improve the industry's culture by direct regulatory intervention was redirected to the UK's traditional approach of self-regulation.

Senior management and certification regime

Following discontinuation of the thematic review of culture, the FCA refocused its strategy towards increasing the personal accountability of financial institutions' key employees.[1083] This strategy is based upon the assumption that an increase in individual responsibility for conduct is an important means of establishing the right culture.[1084] For this, the regulator launched the 'Senior Managers and Certification Regime' ("SMCR"), which aimed to clarify lines of responsibility.[1085]

Under the SMCR, a person of a 'senior management function', who is related with a regulatory breach by a financial institution, is the subject of regulatory and civil liability

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[1079] George Parker and Emma Dunkley, 'FCA denies being pressed by Treasury to drop banking review', *Financial Times* (11 January 2016) < http://www.ft.com/cms/s/0/44e0a70a-b88e-11e5-b151-8e15c9a029fb.html#axzz49HSrvvXc> accessed 21th May 2016

[1080] Financial Conduct Authority, 'Culture in banking' (n1077) 2; The rationale of the sudden stop of the thematic review was provided by the FCA as follows: 'each firm has and needs to have its own approach… We therefore concluded that conducting the second phase of the thematic review was not the best way to achieve the cultural change required bank by bank. The idiosyncratic nature of each individual institution meant that issuing generalised good and poor practice guidance was unlikely to be of sufficient value to justify continuing to focus our resources on the cross-firm work rather than by addressing this firm by firm with individual institutions.'

[1081] See n1078

[1082] The culture review work was handed over to the Banking Standard Boards, which was funded by the banks themselves. As a result, the new attempt to improve the industry's culture by direct regulatory intervention was redirected to the UK's traditional approach of self-regulation; see < http://www.bankingstandardsboard.org.uk/what-is-the-bsb/>

[1083] Interestingly, the idea of personal liability of senior management and directors was already suggested twenty years ago. See SIB, *The Responsibilities of Senior Management,* CP109 (1997)

[1084] Jonathan Davidson, Director of Supervision of the FCA, 'Getting culture and conduct right - the role of the regulator', speech at Cavendish Conference Centre on 12th July 2016, available at < https://www.fca.org.uk/news/speeches/getting-culture-and-conduct-right-role-regulator> accessed 10th March 2017

[1085] It was politically supported by PCBS recommendations and implemented by the Banking Reform Act 2013; see Financial Conduct Authority, 'Senior Managers and Certification Regime' (2015) available at https://www.fca.org.uk/firms/senior-managers-certification-regime accessed 13th May 2017

such as fines, restrictions on responsibilities, and industry ban.[1086] In the draft Banking Reform Act 2013, the government intended to reverse the usual burden of proof, which would have required the senior manager to demonstrate that he/she was not guilty of misconduct in order to avoid personal liability.[1087] The reverse of burden of proof was also called 'presumption of responsibility', which was similar to 'strict liability' in tort.[1088] However, at the last stage of designing the Act, HM Treasury reversed it to 'duty of responsibility', which required the regulator to prove misconduct of the senior manager in order to take regulatory action.[1089] From various sources, it can be assumed that the replacement of 'presumption of responsibility' with 'duty of responsibility' was affected by the financial services industry's opposition to the reversal of the burden of proof.[1090]

Through SMCR, individual employees could be held personally accountable for misconduct; senior managers could be held accountable for their area of responsibility; and other staff could individually be held to appropriate standards of conduct.[1091] Instead of remedying the 'wrong culture' and instilling the 'right culture' by thematic review, the UK regulator reverted to the simple but basic strategy of increasing individual

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[1086] Ibid

[1087] Jay Cullen, 'Culture as Cash, from bonus to malus' in Nicholas Dorn, *Controlling Capital: Public and Private Regulation of Financial Market (*Routledge, 2016) 100

[1088] Iris H-Y Chiu, *Regulating From the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions (*Hart Publishing, 2015) location 6110 (kindle edition); see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 6270 (kindle edition)

[1089] HM Treasury, 'Senior Managers and Certification Regime: extension to all FSMA authorized persons' (2015) 11-12 available at < HM Treasury, 'Senior Managers and Certification Regime: extension to all FSMA authorized persons'> accessed 13th May 2017

[1090] See, for example, Tracey McDermott, acting Chief Executive of the FCA, 'Statement from the Financial Conduct Authority following the announcement by HM Treasury of changes to the Senior Managers' Regime' where she said that '[W]hile the presumption of responsibility could have been helpful, it was never a panacea. *There has been significant industry focus on this one*, small element of the reforms, which risked distracting senior management within firms from implementing both the letter and spirit of the regime.', available at <https://www.fca.org.uk/news/statements/statement-financial-conduct-authority-following-announcement-hm-treasury-changes> accessed 13th May 2017; see also Justin Pugsley, 'Can SM&CR revive banks' reputations in UK?' (the Banker, 28th November 2016) available at < http://www.thebanker.com/World/Western-Europe/Can-SM-CR-revive-banks-reputations-in-UK?ct=true> accessed 13th May 2017

[1091] Financial Conduct Authority, 'Strengthening Accountability in Banking: Senior Managers & Certification Regime' (2015) 5 available at <https://www.fca.org.uk/publication/documents/strengthening-accountability-in-banking-slides.pdf> accessed 13th May 2017

sanction.[1092] The regulator hoped to redirect the culture of the financial services industry by increasing personal accountability, without direct culture-related intervention.[1093]

4.2 Public enforcement in South Korea

4.2.1 Public enforcement cases: 'mis-selling' of OTC derivatives in South Korea

This section analyses the sanctioned cases of 'mis-selling' of over-the-counter derivatives since 2011 in South Korea;[1094] 11 cases have been subject to sanctions (see Table 2). These cases are largely divided into contravention of the (1) suitability and appropriateness rule and (2) 'duty to explain' rule. Through these cases, this section analyses the South Korean regulator's enforcement approach.

Table 2: Regulator's sanction against 'mis-selling' of over-the-counter derivatives in South Korea

Financial institutions	Product	Contravention	Year of sanction	Number of related consumers	Invested amount (thousand US$)	Sanction type
Kookmin Bank[1095]	Derivatives linked collective investment scheme	Appropriateness ('know your customer')	2013	96	3,764	Request of measure
Kyobo Securities Co.[1096]	Equity linked securities	Suitability ('know your customer')	2015	No information	No information	Reprimand

[1092] Jay Cullen, 'Culture as Cash, from bonus to malus' (n1087) 118

[1093] Jonathan Davidson, Director of Supervision of the FCA, 'Getting culture and conduct right - the role of the regulator', speech at Cavendish Conference Centre on 12th July 2016, available at < https://www.fca.org.uk/news/speeches/getting-culture-and-conduct-right-role-regulator> accessed 10th March 2017

[1094] It was from 2011 when the details of sanctioned cases were publicized.

[1095] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201300009&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%B1%B9%B9%CE%C0%BA%C7%E0> accessed 10th March 2016

Financial institutions	Product	Contravention	Year of sanction	Number of related consumers	Invested amount (thousand US$)	Sanction type
Kyobo Securities Co.[1097]	Equity linked securities	Appropriateness	2015	1	No information	Reprimand
Kyobo Securities Co.[1098]	Equity linked securities	Duty to explain	2015	No information	No information	Reprimand
Hyundai Securities Co[1099]	Equity linked securities	Appropriateness ('know your customer')	2015	5	No information	Request of measure
Hyundai Securities Co[1100]	Investment product	Duty to explain	2015	4	No information	Request of measure
Yuanta Securities[1101]	Equity linked securities	Suitability ('know your customer')	2015	No info	No information	Request of measure
Yuanta Securities[1102]	Equity linked securities and fund	Duty to explain	2015	No info	No information	Request of measure
Hana Financial Investment Co.[1103]	ELS	Appropriateness	2015	7	282	Request of measure

[1096]<http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=2&exam_mgmt_no=201400527&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%B1%B3%BA%B8> accessed 10th March 2016

[1097]<http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=2&exam_mgmt_no=201400527&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%B1%B3%BA%B8> accessed 10th March 2016

[1098] Ibid

[1099]<http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201400675&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%C7%F6%B4%EB%C1%F5%B1%C7> accessed 10th March 2016

[1100] Ibid

[1101] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201500222&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%C0%AF%BE%C8%C5%B8> accessed 10th March 2016

[1102] Ibid

[1103] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201500267&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%C7%CF%B3%AA%B1%DD%C0%B6%C5%F5%C0%DA> accessed 10th March 2016

Financial institutions	Product	Contravention	Year of sanction	Number of related consumers	Invested amount (thousand US$)	Sanction type
Nonghyup Bank[1104]	Credit linked private equity fund	Suitability, appropriateness	2016	2	510	Request of measure
Golden Bridge Investment & Securities Co.[1105]	Over-the-counter derivatives	Appropriateness	2016	3	No information	Request of measure

Suitability and appropriateness rule

Sanctions by the South Korean regulator against contraventions of suitability and appropriateness rule are divided into two categories. The first is the breach of 'know your customers' duty. The FISCM Act requires a financial institution's sales representative to assess whether an investor is an ordinary or professional investor;[1106] to obtain information about the 'investment purpose', 'status of wealth', and 'experience in investment' of the 'ordinary investor'; and to receive written confirmation from the investor about his information.[1107]

Financial institutions that didn't obtain information about consumers or the written confirmation stating that the information was correct were sanctioned. For example, a Kyobo Securities Co. sales representative was reprimanded for recommending and selling equity-linked securities to ordinary investors without obtaining the necessary information.[1108] Similarly, Hyundai Securities Co. sales representatives were sanctioned for

[1104] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201400704&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%B3%F3%C7%F9%C0%BA%C7%E0> 4 accessed 10th March 2016

[1105] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201500676&em_open_seq=1&SearchText=&StartDate=20010101&EndDate=20170526&openContent=%B0%F1%B5%E7%BA%EA%B8%B4%C1%F6> accessed 10th March 2016

[1106] FISCM Act Article 46 (1)

[1107] FISCM Act Article 46 (2)

[1108] See n1096

selling derivatives-embedded products to four ordinary investors without obtaining the necessary information.[1109] Kookmin Bank sold derivatives-embedded collective schemes through its Internet homepage without obtaining the investment-related information of investors and was sanctioned due to contravention of the appropriateness rule.[1110]

The second category of sanctions is related to selling high-risk products, which are not suitable or appropriate for ordinary investors' investment propensity. The FISCM Act delegated the work of defining suitability and appropriateness in more detail to the standard WRIR[1111] and, as a result, the types of financial products that are deemed suitable for an ordinary investor's investment propensities have been pre-defined.[1112] Sales of products other than what has been allowed ex-ante for each investment propensity by the standard WRIR is sanctioned as a contravention of the suitability or appropriateness rule.[1113] For example, a sales representative of Hana Financial Investment Co. sold equity-linked securities, categorised as 'speculative high' products, to seven ordinary investors with an investment propensity of 'seeking stability'.[1114] Sales representatives in both Kyobo Securities Co.[1115] and Hyundai Securities Co.[1116] were sanctioned for the same reason.

Duty to explain

Sanctions by the South Korean regulator against breaches of the duty to explain fall into two categories. The first is failing to obtain a signed confirmation, indicating that the ordinary investor understood the explanation of the investment product and its risks. Sales representatives of Kyobo Securities Co.[1117] and Hyundai Securities Co.[1118] were

[1109] See n1099
[1110] See n1095
[1111] Working Rules in Investment Recommendation
[1112] See n755
[1113] See p 1 3 0
[1114] See n1103
[1115] See n1097
[1116] See n1099
[1117] See n1098
[1118] See n1100

sanctioned because confirmation from the ordinary investor was not obtained, irrespective of whether the product was explained.

The second category of sanctions against the breach of 'duty to explain' is the representation of false facts. A Yuanta Securities' sales representative explained that the principal of equity-linked securities was guaranteed when that was not the case, and was therefore sanctioned.[1119]

4.2.2 Approach by the South Korean regulator to enforcement

Focused on sanction

One of characteristics of the sanctioned cases in South Korea is the relatively minor extent of the regulatory breach. Compared to the UK's sanctioned 'mis-selling' cases, where the number of consumers related to each case ranges from 259 to 295,000, [1120] the number for each sanctioned case in South Korea ranges from one to seven. [1121] Another characteristic of the South Korean cases is that the assessment of the regulatory breach was in most cases based on whether the procedural requirements were complied with, instead of on the outcome of consumer damage. For example, in most of the breaches of suitability rule, the required information about the ordinary investor was not obtained; in breaches of the duty to explain rule, the confirmation from the consumer that he/she understood what was explained was not obtained.

The presence of actual consumer damage due to these breaches—which was not mentioned in the final notice—was not an important consideration in determining the sanction. On the other hand, in a similar case in the UK where there was a failure to collect information from the consumer, the sanction was determined based on whether an unsuitable product was sold.[1122] The South Korean regulator bases its determination of whether there has been a sale of an unsuitable product on a comparison of the

[1119] See n1102

[1120] See Table 1 at p 163

[1121] See Table 2 at p 188

[1122] See p 168

investment propensity, identified through a questionnaire, and the level of risk of the invested product—rather than on more substantive elements such as the fitness of the investment for its purpose and the wealth status of investors.[1123] In sum, the sanctioned cases of 'mis-selling' of over-the-counter derivatives in South Korea comprise sanctions against trivial breaches of procedural requirements.

However, not all sanctions by the South Korean regulator concern trivial breaches. For example, although not related to over-the-counter derivatives, Dong-yang Securities Co. was sanctioned in 2015 with 'suspension of business' when it mis-sold around $547 million in commercial paper and corporate bonds issued by its subsidiaries to 11,168 consumers, by stating false facts and recommending unsuitable products.[1124] In other words, the South Korean financial regulator focuses on detection and punishment against regulatory breaches, irrespective of the seriousness of the breach. According to Braithwaite's regulatory enforcement style taxonomy, the South Korean regulator can be classified as the 'token enforcer': proactive in detecting breach, with a tendency to be rulebook-oriented rather than diagnostic, and producing low penalties interpreted as 'a slap on the wrist'.[1125]

A good example of the South Korean regulator's detection- and punishment-oriented enforcement style is 'Comprehensive Examination'. It takes place regularly, when a big team of examiners visits a selected financial institution to examine all business activities since the previous comprehensive examination.[1126] The examination constitutes the main work of the examination departments of the South Korean regulator, and thematic examinations take place only when particular issues are exposed.[1127] Comprehensive

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[1123] See p 1 2 8

[1124] <http://www.fss.or.kr/fss/kr/bsn/announce/openinfo_view.jsp?req_page=null&exam_mgmt_no=201300792&em_open_seq=1&SearchText=&StartDate=20130101&EndDate=20170608&openContent=%C0%AF%BE%C8%C5%B8> accessed 10th March 2016

[1125] John Braithwaite, John Walker and Peter Grabosky, 'An Enforcement Taxonomy of Regulatory Agencies' (1987) 9.3 *LAW & POLICY*, 323, 339-340

[1126] Financial Supervisory Service, '금융회사에 대한 검사 및 제재업무 혁신 [Reform of Examination and Sanction Process]' (2014) 4 available <http://www.fss.or.kr>

[1127] Ibid

Examinations are performed once every two to three years, instead of being triggered by information about a particular contravention or unusual business trend. Since there is no focal theme, the examiner's main task is to detect regulatory breaches by the financial institution. [1128] All breaches—even trivial ones—that are identified through a comprehensive examination, are subject to sanctions.

This shows that there is no risk-based approach [1129] in regularly performed comprehensive examinations across all business areas of a financial institution, and that the regulator's enforcement goal is zero tolerance of regulatory failures. This could be evidence of the regulator's weakness to political risk,[1130] which is inevitably a part of risk-based regulation, and could at the same time be evidence of the desire to maintain control over the financial industry through comprehensive examination.

Focused on personal responsibility

The sanctioned cases of 'mis-selling' of over-the-counter derivatives show that disciplinary action by the South Korean regulator mostly comprises non-monetary sanctions on employees. In all 11 sanctioned cases, the regulator demanded that financial institutions discipline[1131] the implicated employees. This approach of pursuing personal liability for regulatory breaches is connected to the sanction-oriented approach of penalizing all (even minor) detected breaches. As it isn't possible to sanction an individual employee's single regulatory contravention as a failure of the financial institution's internal controls, the possible sanction is to hold the individuals responsible. Alternatively, it can be said that discipline against individuals' trivial wrongdoing has led the regulator to be eager to detect even trivial breaches.

4.2.3 Enforcement strategy of South Korean regulator

[1128] Ibid 1

[1129] See Iain MacNeil, 'The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?' (n1018)

[1130] Julia Black, 'Risk-based regulation: choices, practices and lessons learnt' in OECD, *Risk and Regulatory Policy: Improving the Governance of Risk (*OECD, 2010) 185; see also Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action':A Challenge for the EU' (n1032) 88; see also Sants, FSA Chief Executive, a speech 'UK Financial Regulation: After the Crisis' 12 March 2010, available at <http://www.fsa.gov.uk/Pages/Library/index.shtml> accessed 15th June 2017.

[1131] See n1178

The South Korean regulator has not explicitly announced its enforcement strategy. However, the daily enforcement activities reflect the underlying strategy.[1132] The lack of a formally announced strategy could imply that there is no room to consider any other style of enforcement than 'command and control' style[1133] regulation that is deeply rooted in South Korea's regulatory culture. Under the 'command and control' style regulation, the regulator makes the rules and penalizes anyone who breaches the rules. Thus, such a style of regulation leads to deterrence-oriented enforcement, which focuses on detection and punishment for securing future compliance.[1134]

Deterrence-oriented enforcement

The principal objective of deterrence-oriented enforcement is to enhance regulatory conformity by penalizing the wrongdoers.[1135] Therefore, detecting breach and determining responsibility are critical regulatory processes of enforcement.[1136] Under a deterrence-oriented enforcement strategy, a large portion of the regulatory resource is allocated to detection of breach and most findings of breaches, even if trivial, are penalized.[1137]

[1132] See Peter J. May and Soren C. Winter, 'Regulatory enforcement styles and compliance' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 222-224; Peter J. May and Raymond J. Burby, 'Making Sense Out of Regulatory Enforcement' (1998) 20 *Law & Pol'y* 157, 160, where the authors explained that agency strategy and philosophy of enforcement can be pursued either implicitly or explicitly; see also Marc Schneiberg and Tim Bartley, 'Organizations, Regulation, and Economic Behavior: Regulatory Dynamics and Forms from the Nineteenth to Twenty-First Century' (2008) 4 *Annu. Rev. Law Soc. Sci*, 31, 49, where the authors argued that legal and organizational blueprints, in the process of implementation of rules, rarely emerge.

[1133] See n904

[1134] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 6197-6270; see also Steve Tombs, *Social Protection: After the Crisis (*Policy Press, 2015) 91

[1135] Albert J. Reiss, 'Selecting Strategies of Social Control over Organizational Life' (n929) 23-25

[1136] Ibid; see also Mathew Potoski and Aseem Prakash, 'Voluntary Programmes, Compliance and the Regulation Dilemma' in David Levi-Faur, *Handbook of Politics of Regulation* (Edward Elgar Publishing, 2013) 83-84; see also John T. Scholz, 'Cooperative Regulatory Enforcement and Politics of Administrative Effectiveness' [1991] 85.1 *American Political Science Review*, 115

[1137] John Braithwaite, John Walker and Peter Grabosky, 'An Enforcement Taxonomy of Regulatory Agencies' (1987) 9.3 *Law & Policy* 323, 323-324

The South Korean regulator's deterrence-oriented enforcement is the result of interactions of different social institutions and organizations as explained by Silbey.[1138] Kagan also argued that regulatory enforcement could be affected and shaped by many factors, such as legal design factors, task environment factors, political factors, and leadership factors.[1139] The environmental causes that induced the South Korean financial regulator to adopt a deterrence-focused enforcement approach are discussed below.

The first cause is the precise rule-making system of the South Korean COB regime.[1140] Bardach and Kagan explained that the legalistic enforcement ethos results from the law itself, which is deliberately defined to prevent capture and to ensure strict application of regulations.[1141] The difference between Bardach and Kagan's remark and the South Korean situation is that South Korea's financial regulation is deliberately designed not only for regulatory capture, but also to minimise regulatory discretion.[1142] The rules were developed with maximum clarity, for reducing the enforcer's discretion as much as possible, and for inducing strict and mechanical application at the 'street level'.[1143]

The 'law on the books' works as a powerful constraint on the options at the stage of enforcing.[1144] In the sanctioned cases of 'mis-selling' of over-the-counter derivatives in

[1138] Regulation is produced from the interaction of agency with other organizations and its environment; see Susan S. Silbey, 'The Consequences of Responsive Regulation' in Keith Hawkins and John M. Thomas, *Enforcing regulation* (Springer-Science+Business Media, B.V, 1984) 148; see also Iain Macneil, 'Enforcement and Sanctioning' in Moloney, Niamh, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (Oxford University Press, 2015) n12

[1139] Robert A. Kagan, 'Regulatory Enforcement' in David H. Rosenbloom and Richard D. Schwartz, *Handbook of Regulation and Administrative Law (*Marcel Dekker, 1994)

[1140] See Principle of Clarity in 3.1.2.3 at p 1 0 0 9 9

[1141] Eugene Bardach and Robert Allen Kagan, *Going by the book: The problem of regulatory unreasonableness* (n99) 57; see also Marcel Boyer, Tracy R. Lewis and Wei Lin Liu, 'Setting Standards for Credible Compliance and Law Enforcement' (2000) 33.9 *The Canadian Journal of Economics*, 319, 334, where the authors argued that the style of standards can influence not only behaviour of the regulated but also the behaviour of enforcers.

[1142] See p 1 4 9

[1143] See Neal Shover et al, 'Regional Variation in Regulatory Law Enforcement' in Keith Hawkins and John M. Thomas, *Enforcing Regulation (*Springer, 1984) 123

[1144] Neal Shover, Donald A. Clelland and John Lynxwiler, *Enforcement or negotiation: Constructing a regulatory bureaucracy* (SUNY Press, 1986) 13; see also Robert A. Kagan 'Understanding Regulatory Enforcement' (1989) 11 *Law & Pol'y*, 89, 95; see also Robert Baldwin, 'Why rules don't work' (n308) 328 and 337; see also Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action':A Challenge for the EU' (n1032) 87; see also Julia M Black, '"Which Arrow?": Rule Type and Regulatory Policy' ' (1995) *Public Law* 94 99

South Korea, a large portion was for not receiving written confirmation from ordinary investors about their investment information and their understanding of explanations.[1145] The 'simple' and 'clear'[1146] regulatory requirement[1147] that financial institutions should receive such written confirmation shows without any ambivalence that non-receipt thereof is a breach of regulation, regardless of the reasons or situations.

The second cause could be the regulator's performance evaluation system. Hawkins and Thomas explained that an agency, at the organizational level, might resort to sanction-focused enforcement so as to produce evidence of their actions, rather than evidence of effectiveness.[1148] The reason, they pointed out, was that it was much easier for the agency to show evidence of actions than evidence of effectiveness.[1149] Therefore, there is high possibility that the financial regulator chooses an enforcement strategy focused on sanctions, which makes it easy to evidence its performance. At an individual enforcer level, an enforcer who is subject to such performance criteria for the agency is incentivised to ignore less obvious breaches and concentrate on clear and non-disputable breaches instead.[1150]

The third cause is the weak political influence of the South Korean financial services industry, which is related to the second cause (namely, the performance evaluation system). In a regulatory regime, the enforcement, not only rule-making, has a political nature. Scott stressed that '[a] large portion of individual and even group demands in developing nations reach the political system, not before laws are passed, but rather at the enforcement stage.'[1151] The benefits of regulation are diffused to the general public, but the cost is concentrated on a few regulated;[1152] the regulated community is

[1145] See n1108, n1109, n1117 and n1118
[1146] See n612
[1147] See n653
[1148] Keith Hawkins and John M. Thomas, 'The Enforcement Process in Regulatory Bureaucracy' (n798) 19
[1149] Ibid
[1150] Ibid 10
[1151] James C. Scott, 'Corruption, Machine Politics, and Political Change' (1969) 63.4 *American Political Science Review*, 1142, 1142; see also Adam J. Levitin, 'THE POLITICS OF FINANCIAL REGULATION AND THE REGULATION OF FINANCIAL POLITICS: A REVIEW ESSAY' [2014] 127 *Harvard Law Review,* 1991
[1152] James Q. Wilson, 'The Politics of Regulation' in James McKie, *Social Responsibility and the Business Predicament (*Brookings Institution, 1975) 143

therefore the constituent that most sensitively respond to regulation. The regulated are therefore one of the groups best suited to assess the cost-benefit of regulation, while the regulator, as Richards argued,[1153] doesn't have perfect information about compliance costs, nor the most efficient means of achieving the regulatory outcome.

If a well-established channel exists through which the regulated community can reach the political system, they are able to affect the regulator's enforcement approach. This is possible because the regulated can use the channel to inform political policy makers, who have the power of evaluating and appointing the regulator's top management, with their opinion about the agency's performance.[1154] Shover argued that, when a political conflict was resolved in favour of an 'anti-industry coalition', enforced rather than negotiated compliance was expected.[1155] Kagan expected that legalistic enforcement would render the regulated to organize and attack the regulator at the political level.[1156] A good example is the manner in which the UK financial industry used its strong political influence to stop the regulator's direct intervention, the 'culture review',[1157] and their adoption of 'presumption of responsibility' in the SMCR.[1158]

The first reason for the weakness of the South Korean financial industry's political influence is its insubstantial share of the local economy.[1159] Moloney argued that '[s]upervisory strategy also reflects the extent to which the financial sector represents a significant proportion of local economy'.[1160] While the financial industry comprises 10% of the UK's GDP,[1161] it is merely 6% in South Korea.[1162] Traditionally, the financial

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[1153] Heidi Richards, 'Influence and Incentives in Financial Institution Supervision' (n797) 80

[1154] Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action': A Challenge for the EU' (n1032) 82

[1155] Neal Shover, Donald A. Clelland and John Lynxwiler, *Enforcement or negotiation: Constructing a regulatory bureaucracy* (n1144) 12

[1156] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 74

[1157] See p 1 8 5

[1158] See n1090; see also Norman S. Pose, 'WHY THE SEC FAILED: REGULATORS AGAINST REGULATION' (n1037) 317-319, where the author argued that the implicit alliance between elite financial institutions and politicians made the regulator, SEC to evolve into a mechanism for protecting financial institutions from investors.

[1159] Nancy Reichman, 'Moving Backstage' in Robert Baldwin et al, *A Reader on Regulation (*Oxford, 1998) 340

[1160] Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action': A Challenge for the EU' (n1032) 83

[1161] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 20858

industry was not seen as strategic to the national economy, but rather as supportive for the South Korean manufacturing industry.[1163]

Second, the South Korean financial industry doesn't have a tool by means of which to use political leverage for its interests. As corporations are not allowed to make financial contributions to political parties in South Korea,[1164] the financial industry doesn't have an official and powerful influence tool on politics. In addition, the ownership of South Korean banks is completely dispersed, with no controlling major shareholders who could exercise political influence.

Lastly, external intervention in the enforcement of the South Korean regulator is another driver for its deterrence-oriented enforcement approach. External intervention has induced excessively risk-averse attitudes towards enforcement of regulation in individual officials of the financial regulatory agency. Lipksy emphasized the role of 'street level' enforcers in implementing regulation by saying that 'the decisions of street-level bureaucrats, the routines they establish, and the devices they invent to cope with uncertainties and work pressures, effectively become the public policies they carry out'.[1165] The National Board of Audit and Inspection and the Supreme Prosecutors' Office charged the FSS's individual executives and managers with legal liability for the regulatory failure related to the mutual savings banks' insolvency scandal.[1166] In this case, the National Board of Audit and Inspection sanctioned the relevant officials of the FSS for not having prevented the mutual savings banks from selling subordinate bonds, and the Supreme Prosecutors' Office prosecuted other officials for 'dereliction of duty' in not

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[1162] Financial Supervisory Service '금융회사에 대한 검사 및 제재업무 혁신 [Reform of Examination and Sanction Process]' (n1127１９３)

[1163] See n908

[1164] Cho Soyoung, 'A Constitutional Study on Restrictions on Political Contributions of Corporation' [2016] 17.4 *공법학연구[Public Law Study]* 151

[1165] Michael Lipsky, *Street Level Bureaucracy: Dilemmas of the Individual in Public Service* (Russel Sage Foundation, 2010) location 249-268 (kindle edition); see also Malcom K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance (*Brooking Institution Press, 2011) location 224

[1166] The 'solvency scandal of mutual savings bank' was that 16 mutual savings banks were put into suspension of business in 2011 because of the failure of project financing for real estate development projects.

having prevented the banks' insolvency.[1167] South Korea's detailed rule-making system of financial regulation rendered the regulator's actions or non-actions more challengeable to the external stakeholders.[1168] Such external pursuit of legal liability on the regulatory agency's individual officials, with the benefit of hindsight, has driven individual enforcers to rigidly interpret financial regulation 'by the letter', and to sanction minor breaches in order to avoid the risk of prosecution. Kagan and Scholz pointed out that '[t]hus it is often safer to the inspector personally and for the agency politically to adhere to the rules strictly in all cases.'[1169]

Personal liability focused enforcement

South Korea's deterrence-oriented enforcement approach relies on tracking the personal regulatory liability for each regulatory breach. Only with entity sanctions, the many trivial regulatory breaches detected by proactive investigation cannot be sanctioned.

The design of the regulatory coercive tools is the main reason for the South Korean regulatory regime's focus on personal liability for regulatory breaches. South Korea's FISCM Act stipulates in detail the regulator's means and reasons for disciplinary actions against financial institutions and its employees. The non-monetary disciplinary actions that could be made against financial institutions are 'revoking of business authorization', 'suspension of business', 'institutional warning', and 'institutional caution'.[1170] 'Revoking of business authorization' or 'suspension of business' are very threatening coercive tools, but 'institutional warning' and 'institutional caution' are a form of public censure penalty.[1171]

A 'penalty surcharge' exists for monetary disciplinary actions against financial institutions.[1172] However, this can be imposed on (1) limited and specified cases,[1173]

[1167] See <http://news.naver.com/main/read.nhn?mode=LSD&mid=sec&sid1=101&oid=011&aid=0002391651> accessed 6th October 2017

[1168] Michel Tison, 'DON'T ATTACK THE WATCHDOG! BANKING SUPERVISOR'S LIABILITY AFTER PETER PAUL' (2005) 42 *Common Market Law Review*, 639, 640

[1169] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 80

[1170] FISCM Act Article 420

[1171] In order to increase the deterrent effect of 'institutional warning', the regulator prohibits the entity which is penalized by 'institutional warning' from newly being a majority shareholders of other entities for one years.

[1172] The court can impose *fine* to financial institutions but the fine isn't the scope of this thesis.

which don't include any contravention of the COB, or (2) in lieu of 'business suspension', based on possible earnings during the suspension period.[1174] Therefore, in respect of breach of COB, the regulator can only impose a penalty surcharge on financial institutions in lieu of 'business suspension'. As the penalty surcharge can only be applied in limited cases, it is rarely charged; 89.5% of all the sanctioned entity-level cases between 2012 and 2014 were 'institutional warnings' and 'institutional cautions'.[1175] These limited cases resulted from the concern that a penalty surcharge by a governmental agency would be outside judicial control, even though it has a similar effect as a fine—which is a form of criminal punishment and charged by the Court.[1176]

The FISCM Act specifies the types of sanctions applicable to employees of financial institutions, including 'removal', 'suspension of his/her duty', 'salary reduction', and 'warning', but doesn't cover a penalty surcharge.[1177] The Act stipulates that the regulator can demand that a financial institution sanction the applicable employee, and allows the regulator to directly sanction executive officers.[1178] A sanction against employees and executive officers disadvantage them in that financial institutions cannot appoint[1179] them as an executive officer, nor promote[1180] them for a certain period of time. For example, an employee that has been subject to a 'salary reduction' cannot be appointed as an executive for three years, and is prohibited from promotion or salary increase for

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[1173] Those cases where a penalty surcharge can be imposed are 1) breach of restriction of transactions with the major shareholder, 2) breach of disclosure rule about issuing securities etc., which don't include any breach of COB (FISCM Act Article 428 (1))

[1174] FISCM Act Article 428

[1175] Financial Committee and Financial Supervisory Service, '금융분야 제재개혁 추진방안 [Reform Plan of Sanction in Financial Industry]' (2015) 2 available at <http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=18806&no=1&s_title=%B1%DD%C0%B6%BA%D0%BE%DF%20%C1%A6%C0%E7%B0%B3%C7%F5%20%C3%DF%C1%F8%B9%E6%BE%C8&s_kind=title&page=1> accessed 5th June 2017

[1176] See, for example, Kim Tae Woo, '과징금 제도의 입법론적 문제점과 개선방안 [Problems and Revision of Penalty Surcharge]' (2013) *법제논단 [Discussion of Legislation]* 28, 32

[1177] FISCM Act Article 422

[1178] Ibid

[1179] FISCM Act Article 24; FISCM Act Presidential Decree Article 27 (3)

[1180] Financial Supervisory Service, 제재규정시행세칙 별표 4 [Regulation of Sanction Appendix4]

12 months.[1181] In addition, the record of a regulatory sanction becomes a long-living obstacle to the employee's career, like a criminal record in society; these sanctions therefore act as a very strong deterrent to employees of financial institutions.[1182]

Thanks to this strong deterrent effect, the South Korean regulator has been able to maintain its coercive power over the regulated financial services industry, even without effective coercive tools such as entity-level financial penalties. Data of sanctioned cases during 2012-2014 show the regulator's significant dependence on the disciplinary actions of employees; the percentage of sanctions against employees comprised 73.8% of the all sanctioned cases, while entity-level sanctions against financial institutions comprised 26.2%.[1183]

In summary, 'revoking of business authorization' or 'suspension of business' are effective means of sanction that could be used by the regulator for entity-level breaches of COB in South Korea. However, these tools can only be used for serious contraventions. Therefore, most of the regulator's sanctions are non-monetary sanctions on individual employees.

It isn't correct to interpret the lack of entity-level sanctions against financial institutions as a lack of the regulator's compelling power. Under an enforcement scheme focused on monetary sanctions, the financial penalty could be considered as business costs, and its effect in preventing wrongdoing could be limited—as happened in the UK before the global financial crisis.[1184] The sanction on individual employees is a serious threat because it can damage the employee's personal career; it therefore rather causes an excessively risk-averse attitude. As all decisions and actions in a financial institution are

[1181] Financial Committee and Financial Supervisory Service, '금융분야 제재개혁 추진방안 [Reform Plan of Sanction in Financial Industry] (n1175) 1

[1182] Financial Supervisory Service, '금융회사에 대한 검사 및 제재업무 혁신 [Reform of Examination and Sanction Process]' (n1126) 1

[1183] Financial Committee and Financial Supervisory Service, '금융분야 제재개혁 추진방안 [Reform Plan of Sanction in Financial Industry]' (n1175) 2

[1184] See Parliamentary Commission on Banking Standards, 'Changing Banking for Good' (London: Stationery Office, HC 27-1, HC 175-1, 2013) para 231, available at <www.parliament.uk/documents/banking.../banking-final-report-volume-i.pdf> accessed 15th June 2017

ultimately made and carried out by an individual or a group of individuals, an individual employee's risk-averseness will cause a risk-averse attitude at the institutional level.

The rule-based enforcement scheme, focused on personal sanctions, resulted in a reduced incentive for financial institutions to advance their regulatory compliance strategies and systems. Sanctions against individual employees have no direct formal impact on financial institutions, and the strict rule-based enforcement approach doesn't require each financial institution to develop their own internal compliance system. Due to the detailed rule-making system and the regulator's strict rule-based enforcement approach, a simple compliance strategy of instructing employees to 'just follow and obey the rules' has become sufficient.

Attempt to reform the enforcement

The new government instituted in 2013 selected regulation reform as one of its core policy goals.[1185] Under the policy goal, the financial regulator assessed that an enforcement approach of sanctioning individuals rather than entities didn't change the financial services industry's behaviour, but merely induced employees towards self-protective behaviour; as a result, innovation in the financial industry stagnated.[1186] To address this, the regulator presented two improvement measures.

The first was to expand the scope of when a penalty surcharge could be imposed, and to increase the amounts. The 'Protection for Financial Consumers Bill', which is pending as of the end of May 2017 at the National Assembly, will enable the regulator to charge a penalty surcharge of up to 50% of earnings from the transactions where the financial institution failed to comply with the 'duty to explain'.[1187] If this bill is passed,[1188] the regulator could impose a penalty surcharge on breaches of 'duty to explain' against the financial institution, even if the breach would not result in a 'business suspension'. As a

[1185] <https://www.better.go.kr/zz.main.PortalMain.laf> accessed 6th October 2017

[1186] Financial Committee and Financial Supervisory Service, '금융분야 제재개혁 추진방안 [Reform Plan of Sanction in Financial Industry]' (n1175) 1

[1187] Financial Consumers Protection Bill Article 62 (2)

[1188] The bill has been a pending bill for 5 years and so it isn't guaranteed when and how the bill will be passed.

result, the regulator will have an efficient disciplinary means at the entity level, other than 'business suspension'.

The second measure of enforcement reform was for the regulator to only inform the financial institutions about the contravention of regulation, and have them determine their own level of employee sanctions[1189] rather than directly demanding[1190] a specific sanction against individual employees. This could be an initial attempt at changing the focus of the enforcement on sanctioning employees, but the effect is likely to be limited. First, when the regulator informs the financial institution about the contravention, the institution is required to report the result of employee sanctions to the regulator. [1191] As such, it cannot be said that financial institutions have been given actual autonomy in dealing with the informed breach; the institution can determine the level of sanctions, but not whether to sanction the employee. Therefore, the current enforcement approach of focusing on sanctioning employees isn't likely to change significantly with this measure alone.

On the other hand, this measure will render employee sanctions more informal, and as such remove the right of appeal to the judicial review of the sanctioned employees.[1192] The Supreme Court adjudicated that the action of the regulator informing a financial institution about a breach made by its employees, and demanding the financial institution to take specific action, was only a recommendation and didn't qualify as administrative litigation. [1193] This new measure will only render sanctions against employees more informal, and will make it more difficult for the sanctioned individual to appeal through the court.[1194]

4.3 Evaluation of the enforcement in the UK and South Korea

[1189] Financial Committee and Financial Supervisory Service, '금융분야 제재개혁 추진방안 [Reform Plan of Sanction in Financial Industry] (n1175) 2

[1190] See n1178

[1191] Ibid

[1192] Sanctioned employees can appeal the regulator's decision of sanctions or demand of sanctions to the regulator, itself.

[1193] *Supreme Court 2003 Du 101312*

[1194] It is higly likely that the measure will bring about results that are similar to when the regulator directly determines the sanctions.

Failures of enforcement in achieving outcome

The ultimate purpose of public enforcement of regulation is the prevention of breach.[1195] Under a compliance-focused enforcement approach, the main function is to prevent breaches by assisting the regulated to comply with requirements.[1196] Deterrence-focused enforcement aims to prevent future regulatory contraventions through sanctions on regulatory breach.[1197] Therefore, regulatory breach, especially continuous and large-scale breach, represents failure of enforcement as well as of regulation, under both enforcement styles.

From this perspective, it can be said that enforcement in both South Korea and the UK has not achieved the intended outcome of COB regime. Continued cases of contravention against the suitability rule and communication rule in the UK exist.[1198] These cases are not simple breaches of process but involve contraventions of the spirit of the COB. For example, they include a case where an investment that matures in six years, with a high early-exit fee, was recommended to a customer aged over 70[1199] and another where the deduction of commission from the investment principal was explained as 'no commission'.[1200] The continued occurrence of such cases is evidence of the failure of the UK regulator's enforcement strategy.

In South Korea, it can similarly be questioned whether continuous sanctions—which punish trivial procedural breaches in recommendations properly realizes the spirit of the suitability rule and the 'duty to explain'.[1201] Strict enforcement of a precise rule—for example, requiring financial institutions to obtain consumers' confirmation of awareness of unsuitability of their investment—has excluded consumers from the regulatory

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[1195] Richard Macrory, 'Reforming Regulatory Sanctions-Designing a Systemic Approach' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications (*Oxford University Press, 2010) 230

[1196] See p 2 6

[1197] Ibid

[1198] Table 1 at p 1 6 3

[1199] See n965

[1200] See n957

[1201] See n709

protection web.[1202] The following sections analyse the causes of enforcement failures of the two countries.

4.3.1 The causes of enforcement failures

The UK

A significant portion of the regulated shows the characteristics of the amoral calculator,[1203] which is one of the three types of 'the regulated' as they have been categorized by Kagan and Scholz. Amoral calculators consider regulatory requirements as legal risk in the business rather than duty. Creative compliance, which involves techniques of complying with the letter of regulation while evading the spirit thereof, is the representative compliance strategy of the amoral calculators. A good example is that provisions such as 'no advisory service' or 'no representation' are included in contracts in order to avoid regulatory liability such as the suitability rule and the 'fair communication' rule.[1204] The COBS's prohibition[1205] of financial institutions from using any provision that excludes regulatory liability is an ironic reflection thereof that such an ill-intended but well-informed attitude isn't uncommon practice in the regulated community.

Parker et al. argued that legal professionals, who work as 'gamesters' in the compliance function or in law firms, have encouraged the ill-intended but well-informed behaviour of financial institutions.[1206] For an instance, compliance consulting firms played a significant role in the TCF initiative's failure to produce any outcome and its transformation into a 'procedure project'.[1207]

[1202] See p 1 2 9

[1203] See n155

[1204] See section 5.1.1.6

[1205] COBS 2.1.2R

[1206] Christine E. Parker, Robert Eli Rosen, and Vibeke Lehmann Nielsen, 'The two faces of lawyers: Professional ethics and business compliance with regulation' (2009) 22 *Geo. J. Legal Ethics*, 201, 210-213; see also Steven L. Schwarcz, 'Keynote Address: The Role of Lawyers in the Global Financial Crisis' [2010] 24 Australian Journal of Corporate Law 214; see also Steve Mark and Tahlia Gordon, 'Regulating the legal profession: A Prototype for Change' in Justin O'Brien and George Gilligan, *Integrity, Risk and Accountability in Capital Markets: Regulating Culture (*Bloomsbury Publishing, 2015) location 6329-6476

[1207] Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n935) 29

The UK's suitability rule and the 'fair communication rule' has not become the normative duty for reasons associated with the private law principle of *caveat emptor*. For several centuries, *caveat emptor* has been incorporated in the market economy and has been a strong moral standard in commerce.[1208] The basic spirit of the COB which demands 'best interests' for clients conceptually conflicts with *caveat emptor* which has been the ethical standard in commerce for several centuries.[1209] *Caveat emptor* was already an existing internalized norm in commerce,[1210] while the COB was only supported empirically[1211], rather than being an inherent principle.[1212]

The UK's COB, which didn't hold 'normative license',[1213] needed to rely on legal license to secure compliance. Kagan et al. argued that compulsion is required for a new standard—that isn't yet perceived as a moral duty—to gain normative license.[1214] As Platteau argued, government should be able to 'perform the function of norm supplier' until the standard takes root in the social culture.[1215] However, enforcement in the UK, at least before the global financial crisis, was compliance-focused as many commentators

[1208] Susan S. Silbey, 'The Consequences of Responsive Regulation' (n1138) 149-150; see also Vincenzo Bavoso, 'Filling the Accountability Gap in the Structured Finance Transactions' (2014) 27 available at <http://ssrn.com/abstract=2529413> accessed 24th September 2015; see also William Blair, 'Reconceptualizing the Role of Standards in Supporting Financial Regulation' in Ross P. Buckley and Emilios Avgouleas, *Reconceptualising Global Finance and its Regulation* (Cambridge University Press, 2016) 445-446; see also 5.2

[1209] For details of dissonance between COB and private law, see 5.1.2

[1210] James S. Coleman, *Foundations of social theory* (Harvard university press, 1994) 241

[1211] For example, see Christine Jolls, Cass R. Sunstein, and Richard Thaler, 'A behavioral approach to law and economics' [1998] *Stanford law review* 1471; see also Gerald Spindler, 'Behavioural Finance and Investor Protection Regulations' [2011] 34 *J Consum Policy* 315; see also Maria J. Glover, 'The Structural Role of Private Enforcement Mechanism in Public Law' (2011) 53 *Wm. & Mary L. Rev.* 1137, n155

[1212] Hawkins Keith, *Environment and Enforcement: Regulation and the social definition of pollution* (Oxford University Press, 1984)

[1213] Weak ethical authority of regulation isn't confined in the UK, but inherently regulation has limited ethical foundation compared with law in many jurisdictions.

[1214] Robert A. Kagan, Neil Gunningham, and Dorothy Thornton, 'Fear, duty, and regulatory compliance: lessons from three research projects' (n153) 49; see also Neil Gunningham, Dorothy Thornton, and Robert A. Kagan 'Motivating management: corporate compliance in environmental protection' (2005) Law & Policy 289, 312; see also Jason Johnston, 'The promise and limits of voluntary management-based regulatory reform: an analysis of EPA's Strategic Goals Program' (2005) Faculty Scholarship. Paper 68, 1-2 available at <http://scholarship.law.upenn.edu/faculty_scholarship/68/> accessed 15th June 2017

[1215] Jean-Philippe Platteau, 'Behind the market stage where real societies exist-part II: The role of moral norms' (1994) 30.4 *The Journal of Development Studies* 753, 802

pointed out.[1216] This strategy was the appropriate approach for well-intended and well-informed regulatees.[1217] However, its biggest problem was that the so-called 'bad apples', the ill-intentioned, could easily take advantage of the 'softness' of enforcement. According to Potoski and Praksh, cooperation between the regulator and regulatee is a win-win situation for both sides; however, 'regulation dilemma' exists if one side has more to gain by breaking the agreement of cooperation.[1218] Under compliance-focused enforcement, with its low probability of detection and sanctioning, the most beneficial reaction of the regulated is to evade regulation in order to reduce compliance costs or expand profitability.[1219]

Ferran pointed out that another problem of such opportunistic behaviour is its potential of spreading to others.[1220] The bad apples can be a front desk sales representative with a strong desire for promotion, or a financial institution that is under pressure to show outstanding financial performance to owners or creditors. After observing the bad apples' success in evading regulation, colleagues and competitors could use the same strategy, or at least consider it as business as usual. Edelman and Talesh argued that regulated organizations are affected by social beliefs about legality and morality.[1221] Gleeson stressed that the compliance-focused enforcement strategy is vulnerable to this free-riding behaviour and its spread.[1222] The UK regulator's reactive enforcement lowered the probability of breach detection and, even when detected, punishment was soft.[1223]

[1216] For example, see Daniel Fitzpatrick, *The Politics of Regulation in the UK* (Palgrave Macmillan, 2016) location 66; see also Iain Macneil, 'Enforcement and Sanctioning' (n1138) n10

[1217] Robert Baldwin, *Rules and government* (n108); See Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 75

[1218] Mathew Potoski and Aseem Prakash, 'Voluntary Programmes, Compliance and the Regulation Dilemma' (n1136) 86-88

[1219] Ibid

[1220] Eilís Ferran, 'Capital Market Competitiveness and Enforcement' (2008) available at <SSRN: https://ssrn.com/abstract=1127245 or http://dx.doi.org/10.2139/ssrn.1127245> accessed 6th October 2017; see also Paul Tucker, 'Banking Culture: Regulatory Arbitrage, Values, and Honest Conduct' in Patrick S. Kenadjian and Andreas Dombret*, Getting the culture and Ethics Right (*De Gruyter, 2016) location 2023

[1221] Lauren B. Edelman and Shauhin A. Talesh, 'To comply or not to comply-that isn't the question: how organizations construct the meaning of compliance' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 103

[1222] Simson Gleeson, 'Culture, Supervision and Enforcement in Bank Regulation' in Patrick S. Kenadjian and Andreas Dombret*, Getting the culture and Ethics Right (*De Gruyter, 2016) Location 1362

[1223] Ibid

The value of financial penalties—the main sanction on financial institutions—were such that it could be seen as occasional business costs.[1224] In addition, disciplinary action was not taken against executives who determine the compliance strategy, managers whose duty is to monitor sales practice, and sales representatives who conduct 'mis-selling'. Instead, the financial penalty[1225] imposed on institutions rendered the contravention of COB a procedural breach. The structure that placed all the responsibility for regulatory breach on the entity failed to provide the regulatory requirements with ethical authority. O'Malley argued that 'regulatory fines are intended to produce aggregate effects on the frequency of behaviours rather than correction of individuals'.[1226] Macneil commented that the UK regulator's relying on entity-level financial penalties supported a compliance-focused enforcement approach well, but not a credible deterrence approach.[1227]

An enforcement strategy that relies on entity-level financial penalties is at risk of falling into a 'deterrence trap'. Coffee argued that the penalty for regulatory breach is either not a sufficient deterrence of wrongdoings, or is too large for the regulated to afford.[1228] It is politically and economically difficult for the regulator to raise the entity-level financial penalty to the level of having a realistic deterrent effect. Considering the job losses and systemic disorder associated with the bankruptcy of financial institutions, the application of a financial penalty that could risk the health of the business would be burdensome for regulators. In addition, Kagan and Scholz explained that for the lower level employees who action the malpractice, and the middle level managers who perform monitoring, entity-level financial penalties would be meaningless, with a high possibility that they would have under-estimated the 'regulatory risk'.[1229]

[1224] See p 2 0 2

[1225] See section 4.1.2

[1226] Pat O'Malley, *The Currency of Justice (*Routledge-Cavendish, 2009) 85

[1227] Iain Macneil, 'Enforcement and Sanctioning' (n1138) n58

[1228] John Coffee, 'No Soul to Damn: No Body to Kick': An Unscandalized Inquiry into the Problem of Corporate Punishment' [1981] 79 *Michigan Law Rev*, 386; see also Pat O'Malley, *The Currency of Justice (*n1226) 78, where the author explained that 'administrative fines' do 'not penetrate into the offender's life and apply to merely technical offences that are not accompanied by any feeling of guilt or wrongdoing.'

[1229] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 72

The UK's regulator and policy makers are now addressing the 'regulatory failure' by attempting to enhance the financial services industry's culture through pursuit of the regulatory liability of individual executive officers and key employees.[1230] However, harsh individual punishment[1231] is a potential problem of the UK regulatory regime. According to Black, under the UK's general standard-based regulation system, the regulated are compelled to seek detailed rules for their safety. In terms of regulator, tough enforcement would fall into the 'compliance trap', where the regulator avoids enforcement in fear of political backlash.[1232] In addition, considering the South Korea's experience, it could bring about an extreme risk-averse attitude in employees and executives of financial institutions.[1233]

South Korea

The South Korean regulator's first enforcement failure lay in the fact that there were almost no sanctions against contraventions of the suitability rule or 'duty to explain' rule prior to the large-scale 'mis-selling' of corporate bonds of Dongyang Securities Co.[1234] This is based on Kanda and Milhaupt's argument[1235] that, if the relevant actors ignore an imported rule, the transplant fails. These regulatory requirements came into force through the FISCM Act in 2009. However, it was after the Dongyang Securities Co.'s' 'mis-selling' in 2014 that the regulator announced that it would strengthen the enforcement of the requirements.[1236] Table 2 shows that sanctions against 'mis-selling' of over-the-counter derivatives mostly occurred after 2014. The lack of sanctions prior to 2014 implies that the suitability or 'duty to explain' rules, based on general standard rule,

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[1230] See p 186

[1231] Peter Cartwright, 'Credible deterrence and consumer protection through the imposition of financial penalties: lessons for the Financial Conduct Authority' in Nicholas Ryder, Umut Turksen and Sabine Hassler, *Fighting financial crime in the global economic crisis*: *Law of financial crime* (Routledge, 2014)

[1232] Christine Parker, 'The ''Compliance'' Trap: The Moral Message in Responsive Regulatory Enforcement' (2006) 40.3 Law & Society Review 591, 592-593; see also Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 29-32

[1233] See p 202

[1234] See n1124

[1235] Hideki Kanda and Curtis J. Milhaupt (n792) 891

[1236] Financial Supervisory Service, '금융투자상품 불완전판매 종합대책 [Comprehensive Reaction Plan for 'mis-selling' of Financial Investment Products]' (2014) 4

didn't fit with the South Korean regulator's deterrence-focused and legalistic enforcement style.

Cohen showed that it is very time-consuming and difficult to prove that a sold investment product is unsuitable, or to detect the failure to explain major risks and features of an investment product.[1237] It requires case-by-case examination of the details of each suspected transaction: the sales process, the consumer's experience level, and the environment. Detection and sanction of breach under the COB is difficult, and it is not actively enforced in a deterrence-focused enforcement approach where sanction is the main goal for enforcers.

The large-scale 'mis-selling' scandal of Dongyang Securities Co. also showed the weakness of an enforcement approach oriented in individual-focused sanctions against a rogue financial institution, or the intentional unlawful actions of its top management. It showed that prospective punitive individual-level sanctions are not sufficiently deterrent against employees selling unsuitable financial products or using fraudulent sales practice in accordance with orders from the firm's executive. For the employees, the regulator's prospective career-damaging disciplinary actions were intimidating, but the disadvantage of resisting their manager's orders was a more immediate and direct threat.

After the 'mis-selling' scandal of Dongyang Securities Co., the enforcement cases under the COB increased; however, the sanctioned cases were mostly procedural breaches where confirmation documents were not obtained from customers, rather than breach of substance. Such a process-oriented enforcement approach might result in an increase of hostility against regulation and hinder cooperative compliance; Ayres and Braithwaite

[1237] Stephen B. Cohen, 'The Suitability Rule and Economic Theory' (1971) 80.*8 The Yale Law* Journal, 1604, 1634-1635, where the author pointed out that economic theory explained that suitability rule would make brokers' service expensive because he has to deal with all information of customers, which can be applied to the regulator as well because the regulator also needs to consider all the information of each customers to check legality of recommendation.

warned that an enforcement strategy that is heavily reliant on restrict and adversarial sanction could create an 'organized business culture of resistance to regulation.'[1238]

More importantly, this process-focused enforcement approach in many cases didn't achieve its intended outcome of regulation, but had side effects.[1239] Many sales representatives probably had to endure complaints from customers about being forced to listen to known information or about having to confirm that their product of interest was unsuitable for them prior to investment.[1240] Those sales representatives who accepted such complaints and didn't follow the 'unreasonable' regulatory requirements could become subject to sanction. The sanction-focused enforcement by the South Korean regulator against contravention of the proxy rule is an appropriate strategy for the ill-intentioned and ill-informed regulated, but can bring about hostility to, or at least blind compliance with, regulation in the well-intended regulated.[1241] Process- rather than outcome-focused enforcement results in blind compliance by the regulated, who are also focused more on process than outcome. Sanctions focused on procedural breaches prevent regulatory requirements from becoming normative duty, but instead make them into unreasonable burden.

Considering South Korea in the regulation dilemma situation discussed above,[1242] it can be stated that the regulator deviated from the win-win strategy of cooperative compliance for its short-term goal (detection and sanction).[1243] Strict and legalistic enforcement by the regulator has led to blind compliance with the letters of regulation.[1244]

[1238] Ian Ayres and John Braithwaite, *Responsive regulation: Transcending the deregulation debate* (n945) 20; see also Sidney A. Shapiro and Randy S. Rabinowitz, 'Punishment versus cooperation in regulatory enforcement: A case study of OSHA' (1997) *Administrative Law Review* 713, 718

[1239] See p 1 2 9 ; see also Julia Black, 'Using rules effectively *(*n678) 106

[1240] See n709

[1241] Julia Black, MARTYN HOPPER and CHRISTA BAND, 'Making a success of Principled-based regulation' (2007) *Law and Financial Markets Review* 191, 195

[1242] See n1218

[1243] James C. Cooper and William E. Kovacic, 'Behavioral Economics: Implications For Regulatory Behavior' (2012) 41.1 *J.Regul.Econ* 41, 46

[1244] Mathew Potoski and Aseem Prakash, 'Voluntary Programmes, Compliance and the Regulation Dilemma' (n1136) 86

Enforcement focused on breach of the proxy rule weakened the need for the compliance function in financial institutions. The rule clearly and simply stated the procedures for the individual sales representative, such as receiving confirmation documents; the enforcer used this proxy rule as the main benchmark for its enforcement.[1245] Consequently, financial institutions had no need to establish an advanced internal compliance strategy for implementing the vague and purposive language of the COB. A breach of the proxy rule could only be attributed to personal carelessness, and not to failure of the internal control system. The responsibility for regulatory breach was transferred to the lower part of the organizational hierarchy.

Kagan and Scholz pointed out that enforcement focused on the proxy rule can render the regulated 'incompetent'[1246]: at the entity level, financial institutions no longer need to set up a robust internal control system for achieving the regulatory outcome, and individual employees can fall into blind compliance, being indifferent to the regulatory outcome.

Adoption of the COB based on general standard rules resulted in an unexpected outcome.[1247] The South Korean regulator and the regulated who are used to the command-and-control regulatory culture are experiencing mismatch in enforcement of the COB, which requires cooperative compliance efforts, but is being enforced by the pre-existing command-and-control regulatory culture and institution.[1248]

4.3.2 Theory of regulatory failure

[1245] See Table2 at p 1 8 8

[1246] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 73

[1247] Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'The Transplant Effect' (n948) 170-172; see also Andrew Walter, *Governing Finance: East Asia's Adoption of International Standards (*Cornell University Press, 2008) 29-36, where the author used the term of 'mock compliance' which described that transplanted international standards in the East as is were complied superficially but not substantially.

[1248] Ibid 164-165 where Berkowitz et al. explained empirically that problems from transplanted law stem from ineffective enforcement, rather than from the law on the books; see also Katharina Pistor et al,'Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries' (2003) 18.1 *The World Bank Research Observer* 89, 90

The previous section explained the causes of regulatory failures in COB regimes in South Korea and the UK. This section analyzes the failures of the two countries using the critiques developed in the relevant literature.

The causes of regulatory failures can be theoretically categorized into three types. The first is regulatory capture, which means that the interests of the regulated influences the making and enforcing of regulation and so it deviates from what is originally intended. Stigler argued that the regulated groups use regulation for their advantage by lobbying and that the regulator uses its regulatory power to maintain or increase its authority and transfers wealth from the less organized to the more organized group.[1249]

Peltzman advanced the capture theory arguing that regulation expands on the condition that political power can have advantage in the election by transferring the "rent" to the beneficiary of the regulation, but it contracts when the condition is not met.[1250] Examples of political interference of this theory are found in the COB regimes of the UK and South Korea. The "light touch" enforcement approach in the UK was favoured by the financial institutions, and politicians who needed the financial support of financial institutions actively supported it.[1251] Without the political support for the light touch approach, it is questionable whether the soft enforcement strategy could have been maintained. On the contrary, in South Korea, after the KIKO scandal, politicians raised their voices for adoption of overly strict regulation on financial institutions and they could have political advantages because SMEs in the country had more political influence than financial institutions.[1252] Coffee termed this crisis-driven reform as the "regulatory sine curve".[1253]

The second cause of regulatory failure is that the principal-agent relationship amongst constituents in the regulatory space distorts regulation for the benefit of the agent and

[1249] George J. Stigler, 'The Theory of Economic Regulation' [1971] 2 *Bell J. Econ. & Mgmt. Sci.* 3; William A. Niskanen, 'Bureaucrats and politicians' [1975] 18.3 *The Journal of Law and Economics* 617

[1250] Sam Peltzman et al., 'The economic theory of regulation after a decade of deregulation' [1989] *Brookings paprs on economic activity* 1

[1251] See n1038

[1252] See p 1 3 1

[1253] John C. Coffee Jr, 'Political economy of Dodd-Frank: why financial reform tends to be frustrated and systemic risk perpetuated' [2011] 97 *Cornell L. Rev.* 1019

the intended outcome of the regulation is not achieved. [1254] There is a chain of principal-agent relationships between voters and politicians, politicians and the regulator, and the regulator and the regulated.[1255] For example, the reason that the legalistic mode of enforcement, focused more on the "letters of rule" than the spirit of rules, is prevalent in South Korea is because the regulator is more oriented towards protecting itself (the agent's interests) by enforcing the letters of rules strictly rather than achieving the regulatory objective (the principals' interest). In addition, the multiple principal-agent relationship makes the agency problem more complex.[1256] The thesis analyses how the different incentive of each constituent impacts rule-making, rule-enforcing and the regulatory outcome.

The third cause is that the regulator and the regulated make the worst decision due to mistrust of each other like the two prisoners in the prisoner's dilemma. Through game theory, Sholz showed that there is high possibility that the regulator and the regulated result in uncooperative "deterrence" equilibrium with minimal compliance and strict enforcement even though they will both achieve maximum utility at "voluntary equilibrium".[1257] The previous section showed how South Korea and the UK moved out of the voluntary equilibrium. What led to regulatory dilemma in South Korea was the selection of the strict and adversarial enforcement approach and in the UK some free riders in the regulated community evaded the trust of the regulator and the community.

According to Scholz, the objective of discussing regulatory failure from various theoretical viewpoints is "to inquire into what caused the failures and to ask how those failures can be averted".[1258] The next section discusses how regulatory failure in the two countries can be averted.

[1254] Oliver James, 'Regulation inside government: Public interest justification and regulatory failures' (2000) 78.2 *Public Administration,*327, 336-337

[1255] Ibid

[1256] Pablo T. Spiller, 'Politicians, Interest Groups, and Regulators: A Multiple-Principals Agency Theory of Regulation, or "Let Them Be Bribed"' (1990) 33.1 *Journal of Law and Economics*, 65, 68

[1257] John T. Schloz, 'Cooperative regulatory enforcement and the politics of administrative effectiveness' [1991] 85.1 *American Political Science Review,* 115

[1258] Joshph E. Striglitz, 'Incentives and Institutions in the Provision of Health Care in Developing Countries' (1999) *IHEA Meetings, Rotterdam* 3

4.3.3 Implications from failure

The UK and South Korea's public enforcement of the COB stands at extremes of the spectrum of enforcement style. In the UK, the entity had responsibility for regulatory breach under a compliance-focused enforcement strategy, whereas individual employees were responsible for regulatory breach in South Korea. However, the results from both their contrasting enforcement strategies deviated from the intended outcome of the COB regime. Both countries were in regulation dilemma for different reasons; in the UK, there were some regulatees who broke the trust of the regulator and other compliers, evading regulation as free-riders;[1259] in South Korea, the regulator could be considered as having broken cooperative compliance by applying strict and legalistic enforcement.[1260] While the causes for regulation dilemma in the two countries differ, the commonality is that it is disadvantageous to both the regulator and the regulatee, similar to the prisoners' dilemma outcome.[1261]

After experiencing such regulatory failures, the enforcement reform lead by the policy maker and regulator in both countries interestingly involved the adoption of a part of the enforcement strategy of the other country. The UK adjusted a step in its enforcement in the direction of instituting financial penalties against entities as well as against individuals in the case of regulatory breach, and South Korea made adjustments towards holding individual employees as well as financial institutions responsible.

Since a single-minded strategy such as deterrence-focused or compliance-focused enforcement didn't result in good performance in both countries, it is implied that a balanced enforcement approach is necessary to achieve the intended outcomes of the

[1259] Kyla Malcolm et al., 'Assessing the Effectiveness of Enforcement and Regulation' (2009) *CRA International and City of London, kwiecień,* 37-38

[1260] Keith Hawkins, 'Environment and enforcement' in Browen Morgan and Karen Yeung, *An Introduction to Law and Regulation: text and materials* (Cambridge University Press 2007) 184, where the author argued that 'co-operation cannot be established in the atmosphere of suspicion and distrust that rigid application of the law generates'.

[1261] Heidi Richards, 'Influence and Incentives in Financial Institution Supervision' in A. Joanne Kellerman, Jacob De Haan and Femke De Vries, *Financial Supervision in the 21st Century* (Springer Berlin Heidelberg, 2013) 79

COB regime. This argument has been supported by many scholars.[1262] This implication is also supported by the fact that the regulated consist of subgroups, which are 'amoral calculator', 'citizen', and 'incompetent', each with different compliance motivations.[1263] Scholz proved that, based on game theory, an 'enforcement strategy combining cooperation and deterrence' had a higher probability of better outcomes than a single-minded strategy.[1264] Sparrow stressed that the first priority is to 'realize that each [enforcement] style has its own distinct advantages, so the choice between them is pragmatic, rather than ideological.'[1265]

The UK's compliance-supportive and entity sanction-based enforcement failed to create the individual-level moral standards and transformed COB into internal process and legal considerations.[1266] The attempt to reform culture through persuasion had limited impact on financial institutions, its management, and employees, who are restricted by the 'economic pressures' of a highly competitive market.[1267]

South Korea's individual sanction and procedural breach focused enforcement generated hostility or blindness to regulation in the regulated community and even in consumers,

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[1262] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 17859; see also Christine Parker, 'The ''Compliance'' Trap: The Moral Message in Responsive Regulatory Enforcement' (2006) 40.3 Law & Society Review 591, 592; see also Raymond J. Burby and Robert G. Paterson, 'Improving compliance with state environmental regulations' (1993) 12.4 *Journal of Policy Analysis and Management* 753, 754, where the author empirically proved that balanced enforcement strategy had better outcomes than deterrence focused strategy; see also Kathryn Harrison, 'Is cooperation the answer? Canadian environmental enforcement in comparative context' [1995] 14.2 *Journal of Policy Analysis and Management* 221, where the author empirically showed that purely compliance-based enforcement strategy had shown less effective results than more adversarial enforcement strategy.; see also John Braithwaite, *Restorative justice & responsive regulation* (n151) location 829 (kindle edition) where the author argued the necessity of escalating regulatory reactions to overcome the limit of single minded enforcement strategy; Iain Macneil, 'Enforcement and Sanctioning' (n1138); see also Marver H. Bernstein, *Regulating business by independent commission* (Princeton University Press, 2015) 223

[1263] Robert A. Kagan and John T Scholz, 'The Criminology of The Corporations' (n1046) 85-86; see also Kyla Malcolm et al, 'Assessing the Effectiveness of Enforcement and Regulation' (n1259) 37-38

[1264] John T. Scholz, 'Cooperation, Deterrence, and the Ecology of Regulatory Enforcement' (1984) 18 Law & Soc'y Rev. 179, 219

[1265] Malcom K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance (*Brooking Institution Press, 2011) location 591-592 (Kindle Edition)

[1266] See Fiona Haines, *Globalization and Regulatory Character: Regulatory Reform after the Kader Toy Factory Fire* (Ashgate Pub Co, 2005) 27-36

[1267] Fiona Haines, 'Facing the compliance challenge: Hercules, Houdini or the Charge of the Light Bridge' in in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 288; see also Jay Cullen, 'Culture as Cash, from bonus to malus' (n1087) 109

and as such failed to establish the COB as a norm. Bernstein argued that 'regulation thrives when it is supported by public opinion'; negative recognition of the regulated community and the public on financial regulation will damage the whole regulatory regime substantially.[1268]

How should a balanced enforcement strategy be designed? First, there should be proactive sanction with sufficient deterrent effects against regulatory breach, at least until the COB has secured moral license in the regulated community. The COB, which can be summarised into 'act with best interest of consumer', conflicts with the traditional concepts of legal rights and obligations in commerce of the common law system;[1269] in a jurisdiction such as South Korea, where such regulation was adopted recently, it is difficult to establish an ethical foundation. At least until the COB can secure normative authority in the regulated community, a statutory sanction against the breach is needed.[1270]

The subject of sanction for the breach should not be confined to an employee or entity; the person or entity responsible for the breach must be accurately identified and penalized. Relying only on sanctions against the entity makes regulation into a procedural rather than a normative issue, as is the experience of the UK; merely relying on sanctions against individuals eliminates the entity-level motivation for compliance, as is the experience of South Korea. Sanctions on individuals should include everyone who has liability for regulatory breach, from top management who failed in compliance strategy design, and middle managers who failed in sales practice monitoring, to sales staff at the counter who directly conducted the 'mis-selling'.[1271] Gray and Silbey provided the rationale for this proposal, arguing that compliance is a compilation of actions of

[1268] See Marver H. Bernstein, *Regulating business by independent commission* (n1262) 259-260

[1269] See section 5.1.2

[1270] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 23953 (kindle edition)

[1271] Christine Parker and Sharon Gilad, 'Internal corporate compliance management systems' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 183; see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 21968 (kindle edition); see also Iain MacNeil, 'The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?' (n1018) 358-360

different levels of individuals, and that it is necessary to distinguish between 'managers' and 'workers' in the regulated organization.[1272]

Kagan et al. stressed that the purpose of sanction isn't only to change the wrongdoer's behaviour, but also to remind potential wrongdoers about what is norm and duty.[1273] Therefore, until the COB obtains status as normative duty in the regulated community, penalty must be imposed—not only on large-scale regulatory breaches, but also on smaller ones when there is clear regulatory breach, against both the entity and the responsible employees.[1274] Gray's analysis that minor unpenalized violations could develop 'a cumulative effect in the normalizing of deviance' can be applied to the UK, where the regulator focused its enforcement resources on 'large-scale'[1275] wrongdoings.[1276]

Second, the balanced enforcement strategy is an approach focused on regulatory outcome. Outcome-focused enforcement is a prerequisite for effectiveness from the proactive sanction suggested above. Proactive sanctions focused on process or proxy rule, and not on regulatory outcome, can cause hostility to regulation. To achieve the outcome pursued by the COB, conversation between the regulator and the regulated about the meaning of regulatory requirements such as suitability and fair communication or, in other words, compliance supportive enforcement, is needed.[1277] Black pointed out that in the regulatory space, one of the major causes of regulatory failure is the information asymmetry between the regulator and the regulated; information circulation and integration is therefore important for achieving regulatory outcomes.[1278] Especially,

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[1272] Garry C. Gray and Susan S. Silbey, 'The Other Side of Compliance Relationship' in Christine Parker and Vibeke Lehmann Nielsen, *Explaining Compliance: Business Responses to Regulation (*Edward Elgar Publishing, 2011) 127-

[1273] Robert A. Kagan, Neil Gunningham, and Dorothy Thornton, 'Fear, duty, and regulatory compliance: lessons from three research projects' (n153) 46-47 where the authors called this as 'reminder function'

[1274] Ibid 52

[1275] See p 1 7 2

[1276] Garry C. Gray, 'The regulation of corporate violations: Punishment, compliance, and the blurring of responsibility' (2006) 46.5 *British Journal of Criminology*, 875, 884

[1277] Julia Black, 'Regulatory Conversation' (n930)

[1278] Julia Black, 'Enrolling actors in regulatory systems: examples from UK financial services

the 'command and control' model can suffer from a lack of information flow and integration among the constituents in the regulatory space.[1279]

In a country newly adopting the COB, the regulator and regulated could both have difficulty in understanding the meaning of its requirements. Black argued that one actor in a society might not have all the necessary information to solve social problems. [1280] Rule-makers who transplant regulation from another jurisdiction may conceptually understand the regulation, but may have no idea about its practical implementation within the specific environments of the country's financial market, due to their lack of experience and knowledge of the frontline of the market.[1281] The regulated has difficulty in conceptually understanding the vague and purposive standard rules of suitability and fair communication, which can diverge from the traditional ethics in commerce. The conversation between the regulator and the regulated is the beginning of cooperative compliance for successfully implementing the requirements of the COB and also the beginning of trust building for overcoming regulatory dilemma. Such conversations can result in aspects such as the UK's guidance or publicized policy statements.

If there is insufficient conversation between the regulator and the regulated, which consequently means that two actors in the regulatory space don't understand the meaning of the requirements of the COB, enforcement becomes obsessed with 'form' rather than 'substance'. Black explained this as 'information and knowledge failure' and 'implementation failure' of command and control model. [1282]

Both the regulator and the regulated must have the ability to achieve the intended regulatory outcome in idiosyncratic individual transactions, which can be secured

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Regulation' (2003) Public Law 63, 68-69; see also Steven L. Schwarcz, 'Regulating Complexity in Financial Markets' (n629) 264; see also Jody Freeman, 'The Private Role in Public Governance' (2000) 75.3 *The New York University Law Review* 543, 658

[1279] Ibid 73-74; see also Cristie L. Ford, 'New Governance, Compliance, and Principles-Based Securities Regulation' (2008) 45.1 American Business Law Journal 1, 39-40; see also Edward Rubin, 'The Myth of Accountability and the Anti-Administrative Impulse', (2005) 103 *MICH.L.REV.* 2073, 2131–34

[1280] Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' (2001) 54.1 *Current legal problems* 103, 107

[1281] Cary Coglianese and Evan Mendelson (n676) 28

[1282] Julia Black, 'Critical reflections on regulation' (2002) 2 available at http://eprints.lse.ac.uk/35985/ accessed 15th June 2017

through conversation. South Korea shows the result of enforcement of COB when such conversation is lacking. In South Korea, the rule-maker transplanted the COB with vague and purposive language into the rulebook, and wholly delegated the practical implementation to the association of financial institutions.[1283] As a result, both the regulator and the regulated couldn't develop a shared understanding of what the regulatory substance is.

Third, balanced enforcement is responsive and adaptive to its performance and changing environments.[1284] Moloney pointed that the optimal enforcement strategy isn't fixed.[1285] Many scholars also argued that enforcement is an interaction between the regulator and the regulated, and so the optimal strategy can change depending on the other's action or attitude, as in a dynamic 'game'.[1286] The theory of compliance motivation, which argues that the appropriate enforcement strategy varies depending on the different motivation modes of the regulated, supports that optimal enforcement strategy is relative and dynamic.[1287] Silbey also contended that the failure of regulation is the 'result of the responsiveness of regulatory agencies'.[1288]

The UK financial regulation regime has assessed its enforcement performance and, usually triggered by large-scale scandals or crises, have adapted it to the changing attitudes of the regulated and environments in order to achieve the intended regulatory outcome. South Korea has also assessed that its enforcement approach lacks the support

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[1283] See n677

[1284] Viñals and Jonathan Fiechte, 'The Making of Good Supervision: Learning to Say "No"' (2010) *IMF STAFF POSITION NOTE*, 13 available at <https://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf> accessed 8th October 2017

[1285] Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action': A Challenge for the EU' (n1032) 82

[1286] Mathew Potoski and Aseem Prakash, 'Voluntary Programmes, Compliance and the Regulation Dilemma' (n1136), where the authors explained the result of enforcement and compliance strategy by game theory.; see also Rose Nicholas. *Powers of Freedom: Reframing Political Thought* (Cambridge, 1999) 4, where the author said that governance was 'to act upon action'; see also Doreen McBarnet and Christopher Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *Mordern Law Review*

[1287] Robert A. Kagan, Neil Gunningham, and Dorothy Thornton, 'Fear, duty, and regulatory compliance: lessons from three research projects' (n153); about motivating compliance; see also Wayne B. Gray and Ronald J. Shadbegian, 'When and why do plants comply? Paper mills in the 1980s' [2005] 27.2 *Law & Policy*, 238; see also Susan S. Silbey, 'The Consequences of Responsive Regulation' (n1138) 165

[1288] Susan S. Silbey, 'The Consequences of Responsive Regulation' (n1138) 148-149

of the regulated community and is therefore also attempting reform. An enforcement strategy that currently works well can gradually impact the regulated or the regulator's attitude and become less successful. Technology development or change of practice in the financial market can also render a well-performing enforcement strategy obsolete.

Weaver argued that in order to design a responsive enforcement strategy, the ability to adjust the conflicting interests among stakeholder including the regulatory agency, the regulated community, Congress and press is needed.[1289] It isn't only financial institutions that are susceptible to short-termism.[1290] As in the UK's 'culture review' example, the regulator could also fall into short-termism, trying to produce visible results in a short time.[1291] The termination of the UK regulator's 'culture review' project indicates that the check and balance against the regulator in the regulatory space is functioning.[1292] Based on the UK's journey to find an optimal enforcement strategy, it can be seen that a responsive enforcement strategy can be achieved when cooperation and checks in the regulatory space function harmoniously.[1293]

4.3.4 Further actions needed

The UK

The UK must closely monitor the effect of the sanctions applied to employees through the SMRC on regulatory performance. As analysed in the previous section, based on the

[1289] Paul Weaver, 'Regulation, Social Policy, and Class Conflict' (1978) 50 *Public Interest*, 45, 52-54; see also Neal Shover, Donald A. Clelland and John Lynxwiler, *Enforcement or negotiation: Constructing a regulatory bureaucracy* (n1144) 132

[1290] John Kay, 'The Kay review of UK equity markets and long-term decision making. Final Report' *(*n1073), where the author criticized the short-termism of financial services industry; see also James C. Cooper and William E. Kovacic, 'Behavioral economics: implications for regulatory behavior' (n1243) 42-50; see also Niamh Moloney, 'Supervision in the Wake of the Financial Crisis: Achieving Effective 'Law in Action':A Challenge for the EU' (n1032) 79-80

[1291] See p 1 8 5 ; see also Matthew Potoski and Aseem Prakash, 'Voluntary programs, compliance and the regulation dilemma' (n824) Edward Elgar Publishing, 2013) 86-88

[1292] Salo Coslovsky et al, 'The Pragmatic Politics of Regulatory Enforcement' (n824) 322

[1293] See section 5.1.3; the media can also play a significant role in finding the 'right' policy of financial regulation and enforcement. For example, see https://www.ft.com/content/26150484-b928-11e5-bf7e-8a339b6f2164?mhq5j=e1; see national style of regulation

UK and South Korea's experience, pursuit of personal liability for regulatory breach is a double-edged sword. Employee penalty is necessary in order to make the COB a normative duty, and sanction is needed to strengthen the deterrence effect; however, potential side-effects are undeniable. Personal sanctions can destroy a senior manager's career and damage the career of middle and lower level employees.[1294] Enhanced personal liability can therefore be a strong deterrent force against wrongdoing, but can at the same time render a defensive culture in the financial services industry.[1295] The probability of personal liability can make employees cautious to take innovative steps which differ from old and safe practice.[1296] The defensive culture could also result in excessive proceduralism by employees attempting to produce evidence that could avoid prospective personal liability.[1297]

Further, it needs to be seen whether employee-level penalties function well in harmony with the UK's general standard rule-making system. Black explained that the general standard rule-making system is 'a re-framing of the regulatory relationship from one of directing and controlling to one based on responsibility, mutuality, and trust',[1298] and warned that the general standard rule-making system may not work well without trust between the regulator and the regulated.[1299] Pursuing personal liability is a sign of the regulator's mistrust of the financial institutions' capacity and goodwill to comply with regulation. Harsh punishments can cause the regulated to resort to conservative

[1294] Peter Cartwright, 'Credible deterrence and consumer protection through the imposition of financial penalties: lessons for the Financial Conduct Authority' in Nicholas Ryder, Umut Turksen and Sabine Hassler, *Fighting financial crime in the global economic crisis*: *Law of financial crime* (Routledge, 2014) 44-46

[1295] Iris H-Y Chiu, *Regulating From the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions (*Hart Publishing, 2015) location 6136-6174; see also Iain MacNeil, 'The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?' (n1018) 360

[1296] Ibid; for detailed discussion of financial innovation, see Emilios Avgouleas 'Regulating Financial Innovation' in Baldwin, Robert, Martin Cave, and Martin Lodge, *The Oxford handbook of regulation* (Oxford University Press, 2010)

[1297] Ibid

[1298] Julia Black, 'The rise, fall and fate of principles based regulation' (n820) 12; see also Julia Black, 'Forms and Paradoxes of Principles Based Regulation' (n932) 25-35

[1299] Julia Black, 'The rise, fall and fate of principles based regulation' (n820) 15-17

interpretation of general standards, or to seek detailed rules from the enforcer for safety, which could result in the failure to achieve the purpose of the general standard rules.[1300]

South Korea

South Korea, with its personal sanctions-focused approach, has recently made a meaningful attempt at reform through the strengthening of entity sanctions. However, this reform is also an attempt to improve the deterrence effect within the strategy of deterrence-focused enforcement. Still, the detection and sanction of regulatory breach is central to enforcement. Judgement of regulatory breach is also mostly process- rather than substance-based.

In South Korea, which has only experienced command-and-control style regulation, it isn't an easy task to implement a balanced enforcement strategy. It requires the whole regulatory system to shift from command-and-control regulation to decentred regulation.[1301] As a start towards balanced enforcement, detailed process-focused rules need to change to outcome-focused rules. For the latter to work in reality, a cultural infrastructure must be established.

The first element thereof is the regulated and the regulator's professionalism. Jackson and Roe argued that absence of professionalism in the regulatory agency is a constraint on a compliance-focused enforcement strategy.[1302] Professionalism, here, refers to the ability of the regulated and the regulator to apply the general standard rules which directly ascribe regulatory outcome to various circumstances. The regulated should harness their capacity to secure compliance with the general standard rules. This capacity includes a self-regulation ability, which enables the regulated to interpret and implement

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[1300] Ibid

[1301] Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' (n1280) 145-146

[1302] Howell E. Jackson and Mark J. Roe, 'Public and private enforcement of securities laws: Resource-based evidence' (2009) 93 *Journal of Financial Economics*, 207, 235; see also Neal Shover, Donald A. Clelland and John Lynxwiler, *Enforcement or negotiation: Constructing a regulatory bureaucracy* (n1144) 134-135; see also Cary Coglianese, 'Performance-based regulation: concepts and challenges' in Francesca Bignami and David Zaring, *Comparative Law and Regulation (*Elgar, 2016) 387-403, where the author argued that outcome oriented regulation can work under condition that the regulator has capability to assess the regulatee's performance accurately.

the regulatory requirements in their internal management system.[1303] The capacity also requires the ability and culture of communication with the regulator and other financial institutions about implementation of general standard rules.

For enhanced professionalism of the regulated, Parker stressed the importance of the roles of compliance professionals to 'act as mediators' between the regulator, the regulatee, and the regulated community.[1304] He explained that a compliance-oriented enforcement strategy has a higher possibility of success when compliance professionals understand and share the meaning of the regulatory requirements with the business.[1305] McCaeffery and Hart showed from their empirical research on Wall Street that direct support from senior management is necessary for compliance professionals in financial institutions to properly perform their role.[1306]

The professionalism of the regulator means that the regulator understands the intended outcome of regulation, nurtures the ability of the regulated to achieve the regulatory outcomes, and has the capability to assess whether the outcomes have been achieved. Wilson pointed out that the more individual officers of the regulatory agency lack the professionalism, the more reliance on simple and clear rules is required.[1307]

The second element of the cultural infrastructure is an environment where the conversation between the regulator and the regulated can occur. Such conversation is necessary for reaching a shared understanding of the regulatory requirements.[1308] Without conversation, enforcement of the general standard rule can have unintended

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[1303] Peter N. Grabosky, 'Using non-governmental resources to foster regulatory compliance' [1995] 8.4 *Governance* 527; See also THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS 'COMPLIANCE FUNCTION AT MARKET INTERMEDIARIES' (2006) 8 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD198.pdf. accessed 25th October 2016

[1304] Christine Parker, 'Reinventing regulation within the corporation: compliance-oriented regulatory innovation' (2000) 32.5 *Administration & Society,* 529, 553; see also Parker, 'Compliance professionalism and regulatory community: The Australian trade practices regime [1999] 26.2 Journal of Law & Society, 215

[1305] Christine Parker, 'Reinventing regulation within the corporation: compliance-oriented regulatory innovation' (n1304) 556

[1306] David P. McCaffrey and David W. Hart, *Wall Street polices itself: How securities firms manage the legal hazards of competitive pressures* (Oxford University Press on Demand, 1998) 157; see Securities Industry Association, 'The Role of Compliance' [2005] 6.3 *Journal of Investment Compliance* 4

[1307] James Q. Wilson, *Bureaucracy (*Basic Books, 1989) 344

[1308] Julia Black, 'Talking About Regulation' [1998] 1 *Public Law* 77

consequences. Haines argued that a difference between compliance and harm reduction can persist, and that legal compliance doesn't guarantee reduction of the real risk.[1309] The adoption of the suitability or 'duty to explain' rule in South Korea serves as example: as vague requirements were implemented without cooperation between the regulated and the regulator, both actors focused on the compliance and enforcement of the proxy rule. With respect to the regulator, the evaluation system for its performance at the agency level as well as the individual level should place more weight on nurturing the compliance capacity of the regulated than on detecting and sanctioning breaches. This is an adjustment to the regulator's incentive structure, so that cooperation becomes beneficial individually and collectively.[1310] The performance evaluation system is also related to the accountability of the regulator: 'compliance accountability' or 'performance accountability'.[1311]

With respect to the regulated, financial institutions should be prepared to invest in resources for advancing their own compliance capability for implementing purposive regulatory requirements.[1312] In fact, compliance with general standard rules is much more expensive than precise rules.[1313] Instead of demanding simple and detailed regulatory rules, co-understanding of the goal of regulation should be developed through cooperation with the regulator. Instead of assigning the responsibility for regulatory compliance to the employee,[1314] there should be a sense of responsibility to comply with the spirit of regulation and strengthen the internal compliance system.

[1309] Fiona Haines, 'Facing the compliance challenge: Hercules, Houdini or the Charge of the Light Bridge' (n1267) 294

[1310] Matthew Potoski and Aseem Prakash, 'Voluntary programs, compliance and the regulation dilemma' (n824) 88-92

[1311] Christopher Hood, et al, *Regulation inside government: Waste watchers, quality police, and sleaze-busters* (n894) 6-7; see also Robert R. C. Pires, 'Beyond the fear of discretion: Flexibility, Performance, and Accountability in the Management of Regulatory Bureaucracies (2011) 5 *Regulation and Governance* 43, 62

[1312] For example, in 2004 Citigroup made a position of Director Ethics who implement regulatory guidelines, applicable laws and ethics in a business context; see Justin O'Brien, *Redesigning Financial Regulation (*Wiely, 2006) 111

[1313] Peter N. Grabosky, 'Using non-governmental resources to foster regulatory compliance' (n1303) 559-560

[1314] William S. Laufer, 'Corporate Liability, risk shifting, and the paradox of compliance' [1999] 54 *Vanderbilt Law Review,* 1343

Conclusion

The chapter examined the enforcement strategy of South Korea and the UK by analysing the enforcement cases of the two countries. The UK has continuously changed its enforcement strategy beginning with the light touch to TCF, to culture review and recently to SMCR. All the enforcement strategies before SMCR were compliance-focused approaches. These strategies took the stance of trusting the goodwill of the management and employees of financial institutions and helping them to improve their internal control systems to facilitate compliance. However, as the UK regulator admitted, it failed to achieve the regulatory objective with just a compliance-oriented enforcement strategy. Based on review of such failures, the UK adopted the SMCR which allows for individual sanctions, a deterrence-focused enforcement approach.

On the contrary, South Korea demonstrated the failure of deterrence-focused enforcement strategy. South Korea adopted general standard rules such as the suitability rule or duty to explain but the legalistic approach in enforcement was not appropriate for enforcing such general standard rules. The deterrence-oriented and legalistic enforcement of South Korea focused not on the spirit of general standards but sanctioning the breach of proxy rules. Sanctioning of non-compliance with the process as set out by the proxy rule created the outcome where regulatees are only interested in complying simply with the "letters of rules" without any interest in achieving the regulatory objective. Such unreasonable situations, where regulation produces results remote from its objective, breeded hostility and ignorance towards regulation. This explanation about why the enforcement strategy failed in the two countries is the answer to the third research question[1315].

The chapter proposed a balanced enforcement approach to resolve the regulatory failures of the two countries. A balanced enforcement approach must have the following: first, proactive sanction with sufficient deterrent effects against regulatory

[1315] What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?

breach; second, focus on regulatory outcome; and third, responding and adapting to its performance and changing environments.

V. PRIVATE LAW IN 'MIS-SELLING' OVER-THE-COUNTER DERIVATIVES

Introduction

The previous chapter analysed the regulatory agency's enforcement of statutory regulation. However, the institutions for the enforcement of COB also comprise private enforcement through litigation.[1316] COB intervenes with the seller's behaviour in contractual relationships—traditionally an area of private law. In other words, the COB governs at the intersection of private law and public regulation, which can have diverging aims.[1317] The defining of the relationship between private law and regulation is an important design consideration of a COB regime.[1318] This chapter discusses how to coordinate public and private enforcement—the two enforcement institutions of the COB regime.

Two types of issues dominate in the coordination of public and private enforcement. The first is the problem of what to enforce.[1319] There isn't much disagreement that public enforcement is for statutory regulation; however, enforcement by the court, which is an agency of private enforcement, is unclear—especially where dissonance exists between the legal order of private law and public regulation. One option is to allow the judge

[1316] Lauren B. Edelman and Shauhin A. Talesh, 'To comply or not to comply-that isn't the question: how organizations construct the meaning of compliance' (n1221) 114; for an economic perspective of private enforcement, see also Anthony I. Ogus, 'Better Regulation-better enforcement' in Stephen Weatherill, *Better regulation* (Bloomsbury Publishing plc, 2007) 119-121

[1317] Alaistar Hudson, 'The synthesis of public and private in finance law' in Barker, Kit, and Darryn Jensen (eds), *Private law: key encounters with public law* (Cambridge University Press 2013) 234; see also Vanessa Mak, 'The 'Average Consumer' of EU Law in Domestic and European Litigation' in D Leczykiewicz and S Weatherill (eds), *The Involvement of EU Law in Private Law Relationships* (Studies of the Oxford Institute of European and Comparative Law, Hart Publishing, Oxford 2013) 333-356; see also Alan Schwartz, 'Contract theory and theories of contract regulation' in Eric Brousseau and Jean-Michel Glachant (eds), *The Economics of Contracts* (CAMBRIDGE UNIVERSITY PRESS, 2002) location 1587, where the author explained advent of 'contract regulation' which the COB can be one example of.

[1318] Hans-W Micklitz, 'Administrative Enforcement of European Private Law' in Roger Brownsword et al**,** *The Foundations of Europeans Private Law (*Hart Publishing, 2011**)** 569-570; see also Susan Rose-Ackerman, *Rethinking the progressive agenda* (Simon and Schuster 1993) ch 8

[1319] Anthony I. Ogus, 'The Regulation of Services and The Public-Private Divide' in Fabrizo Cafagi and Horatia Muir Watt, *The Regulatory Function of European Private Law (*Edward Elgar, 2009) 7-8

discretion to reference or not reference a public regulation on each case; the other option is that public regulation binds the court's decision through legislation.

The second consideration is how to combine the two enforcement institutions.[1320] This issue is deeply related to the strengths and weaknesses of each enforcement institution, and relates to the respective roles of public and private enforcement in the COB regime. The UK and South Korea have significantly different approaches to the private enforcement of the COB regime. Through a comparative study of the two countries, this chapter can answer the fourth research question[1321].

5.1 Private law in the UK

5.1.1 Private law in 'mis-selling' over-the-counter derivatives

In the UK, breach of the COBS doesn't necessarily entitle compensation under private law. FSMA 2000 provides right of action for damage due to a regulatory breach to private persons alone.[1322] This right, provided to a private person, doesn't bind the court's related adjudication.[1323] Therefore, to understand the UK's private enforcement of COB, private law without interference of public regulation must be examined first. This section reviews the UK's private law principles about 'mis-selling' disputes of over-the-counter derivatives, as well as its relationship with the COB.

5.1.1.1 Major issues in the private law

The 'mis-selling' cases, where consumers alleged that they were misled to enter into over-the-counter derivatives contracts, were brought to court in the UK since the 1990s. Although the disputes arose in different circumstances in each case, four main issues were common across those cases: (1) a duty of care imposed on financial institutions; (2)

[1320] Ibid
[1321] Ibid
[1322] See p 2 4 1
[1323] ibid

misrepresentation by financial institutions; (3) application of regulatory rules to financial institutions; and (4) causation.[1324]

Major issues

Over-the-counter derivatives are one of the products that resulted in imbalances of knowledge and expertise between financial institutions and consumers.[1325] Selling these products usually involves a series of explanations and discussions between the financial institution and the consumer about the consumer's and the product's characteristics. The

[1324] Before examining these four issues, by looking at an example case in detail, the nature of each issue can be better understood. The example is the *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc*.[2010] EWHC 211. The claimant was Titan Steel Wheel ("Titan") which was a manufacturer of steel wheels for vehicles. Its income was earned predominantly in euro because the majority of its products were sold in the European continent, while its costs were incurred in sterling. So it was exposed to significant exchange rate risk. In order to cope with the risk, it purchased structured over-the-counter derivatives from the Royal Bank of Scotland ("RBS") in 2007.
In February 2007, Titan purchased three structured products of euro/sterling swaps from the RBS to hedge its exchange rate risk. The basic structures of all three products were the same. If the actual currency rate at the end of a month is above "the upper rate" (1.478 euro/pound), Titan could sell a certain amount (1.65 million) of Euro at "the upper rate" (profit situation). If the actual rate at the month end went down below the lower rate (1.45 euro/pound), Titan should sell twice the amount (3.3million) of euro at "the upper rate" (loss situation). If the spot currency rate was between the upper and lower rate, Titan had no obligation or right to sell Euro. In other words, Titan protected itself against the risk of the Sterling strengthening above "the upper rate" but for the price of protection, it had to hold the risk of loss when the exchange rate went down below the lower rate. As the euro/sterling currency rate happened to go down below the lower rate slightly after the purchase of the February currency swaps, both parties started to have discussions about restructuring the deals from mid-April. Discussion was mainly done between the financial controller of Titan and the RBS's corporate treasury manager. After a couple of months of discussions, in June 2007 they restructured the February deals into a single contract with changes to the upper and lower rates and other minor conditions. In the restructured deal, "the upper rate" was changed from 1.478 to 1.467 and "the lower rate" from 1.4500 to 1.4285, and the contracted amount increased from €1.65 million to €2 million. Although the closing out of the previous deals cost about €180,000 to Titan, this fact was not raised or reported to Titan by RBS before the restructured deal was executed. This cost was carried forward into the restructured deal. In September 2007, RBS sent an e-mail containing a proposal for a new swap product which was more speculative. This product had a condition of an 'accrual rate', which was such that when the spot currency rate went over the accrual rate, Titan could sell 0.5 million euro at the accrual rate, while when the currency rate went below the accrual rate, it should sell 1 million euro at the accrual rate. In addition, there was a 'knock-out' condition under which the deal would be terminated when the profit Titan earned on the deal became more than 10 cents per euro. The key differences between the September deal and the June deal were two things. Firstly, the probability of loss to Titan increased dramatically because it had to bear loss just when the spot rate goes down below the 'accrual rate' not the "lower rate". Secondly, with the profit cap, the profit Titan might earn from this swap deal was limited while the loss it could have to bear was unlimited.
After a couple of discussions with RBS, Titan decided to purchase the September product when the spot rate of euro/sterling was 1.44 in September 2007. However, the euro/sterling rate started tumbling down from November 2007 and reached the historical low point of almost 1.0 at the end of 2008. As a result, Titan suffered a huge loss.

[1325] See section 2.2.2.3

Titan case exemplifies very well the complex structures of over-the-counter derivatives, their marketing strategies, and the communication between the two parties.[1326]

When an alleged 'mis-selling' case is brought to court, the consumer usually claims that she was 'advised' to enter into the contract, and that the financial institution breached its duty of care as adviser. Here, the first issue arises: what duty of care is imposed on a financial institution that sells over-the-counter derivatives?

The consumer usually contends that the institution misrepresented the risk or material characteristics of the over-the-counter derivatives, and that they were misled to enter into the contract. The second issue arises: what kind of communication can be seen as misrepresentation in transactions of over-the-counter derivatives?

Third, consumers allege that they have a statutory 'right of action' for financial institutions' breach of regulatory duty.[1327] This issue relates to the application of this 'right of action': who is entitled thereto, and how is this right applied to civil cases?

Lastly, if breach of private law standards or regulatory rules is found, the consumer should prove that his loss is caused by the breach in order to obtain compensation. The dispute here relates to what is required for the claimant to prove causation.

These issues are explored below through relevant cases, thus helping to develop an understanding of the approach of private law.

5.1.1.2 Duty of care

In claiming financial institution's negligence in over-the-counter derivatives transactions, the first dispute relates to the extent of any 'duty of care' that is owed by the seller—more specifically whether the financial institution has a duty of care as advisor. The court's view on this aspect is wide ranging and onerous.[1328] Whether the seller of over-

[1326] Ibid

[1327] FSMA 2000 s 138D (6); FSMA 2000 s 150

[1328] An advisor's duties include knowing the consumer's investment objectives and attitudes to risks, presenting investment opportunities in accordance with such objectives and risk attitudes, informing the consumer of accurate prices, and taking care of the consumer's investment diversity; see Alaistar Hudson, *THE*

the-counter derivatives is an advisor or not is decisive in defining her duty of care in private law. This is one of the fiercest battlefields in disputes of 'mis-selling' of over-the-counter derivatives.

Existence of advisory relationship

Case law of the 'mis-selling' of over-the-counter derivatives shows that the court consistently uses contractual terms as the prime criteria for determining the existence of an advisory relationship. This is in line with the common law principle that a contractual agreement between parties on how to transact establishes the scope of responsibility and duty of the parties.[1329]

Court's decisions regarding the existence of advisory services are based on the following propositions. First, the court differentiates the 'legal' from the 'factual' advisory relationship.[1330] It proposed that the legal relationship between the financial institution and the consumer was dependent on contractual terms, and couldn't be affected by the factual relationship.[1331] Second, the contract of providing advisory service significantly indicates the existence of an advisory relationship.[1332] On the contrary, the absence of such a contract could imply that the financial institution has no advisory obligation.[1333] Third, financial institutions and consumers can define their relationship contractually, so that the allocation of transaction-related risks between the two parties can be optimised.[1334] Contractual terms can define the obligation and right of each party in the transaction.[1335] Lastly, the contractual terms allocating the obligation and right of the two parties prevent one party from asserting a claim based on a reality which is different from the agreed terms.[1336] This means that the consumer who agreed to a contractual

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LAW OF FINANCE (n 413) para 25-35; see eg *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [616]

[1329] *Henderson v Merrett* [1995] 2 AC145; George Walker, Robert Purves, and Michael Blair QC (n 426) para.7.11

[1330] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73] (1)

[1331] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) [544]

[1332] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73] (2)

[1333] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [440]

[1334] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73] (3)

[1335] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [475]

[1336] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133 [73] (4)

term stipulating that the financial institution doesn't provide advisory service cannot assert that he relied on an advice that was provided.[1337] The contract provides *contractual estoppel*.

In the case of *Titan Steel Wheels Ltd v The Royal Bank of Scotland Plc*, all of the contractual documents described that the bank would not provide advisory services, and that any opinions expressed by the bank should not be treated as advice.[1338] The court declared that it had no reason to interpret the contractual terms in other ways.[1339] The court supported its decision by showing that there was no paid an advisory fee, and that Titan didn't request advice.[1340]

In the case of *Bankers Trust International Plc v Dharmala Sakti Sejahtera,* the court also rejected the bank's duty as an advisor: Dharmala didn't ask the financial institution to be an advisor, and Dharmala indicated a substantial capability to understand and evaluate investment proposals for itself. [1341]

In addition, contractual terms of disclaiming advisory service estopped an unsophisticated individual from asserting an advisory relationship. *Green & Rowley v The Royal Bank of Scotland Plc,*[1342] showed that this disclaimer could prohibit individual consumers from claiming on negligent advice. The owner of a small hotel claimed that he had been recommended and pushed by the bank to enter into the swap, while the bank denied any recommendation and insisted that it only provided information about different products. The court referred to the disclaimer in the contractual documents, stating that the bank would provide the consumer with an execution-only service and would not provide advice.

[1337] See eg *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) [544]; *Peekay Intermark Limited, Harish Pawani v Australia and New Zealand Banking Group Limited* [2006] EWCA Civ 386 [56]

[1338] [2010] EWHC 211 [78]-[83]

[1339] Ibid [88] where the position was that 'a person who signs a document knowing it is intended to have a legal effect is generally bound by its terms there.'; *L'ESTRANGE V GRAUCOB* [1934] 2 KB [394]

[1340] *Titan Steel Wheels Ltd v The Royal Bank of Scotland Plc* [2010] EWHC 211 [94]

[1341] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518

[1342] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661

The *Crestsign Ltd v National Westminster Bank Plc and Royal Bank of Scotland Plc* case[1343] illustrates the importance of the clause defining the scope of the contract. The court accepted that the bank, in reality, provided advice about IRHPs, and stated that the advice was negligent. However, it adjudicated that it didn't constitute breach of duty of care, and was not actionable, because of the disclaimer denying the provision of advisory service.

Where a financial institution did contract to provide an advisory service, it was free from the liability of negligent advice by *an exclusion of liability clause. In Camerata Property Inc v Credit Suisse Securities (Europe) Ltd*,[1344] the advisory service agreement included a provision that the financial institution would be liable only for 'grossly negligent' advice. Accepting the effect of this disclaimer, the court held that the financial institution would be liable only under the condition of 'gross negligence', which the court considered a higher level of negligence.

Low-level duty of care

Under the non-advisory service relationship, what kind of a duty of care would financial institutions selling over-the-counter derivatives hold? In *JP Morgan Chase Bank and Others v Springwell Navigation Corporation*,[1345] the court analysed that the financial institution proffered neither advice nor merely an execution-only service. Even though there was no contractual clause for provision of 'advice', the court accepted that personal recommendations or advice was given in reality. The court stated that the financial institution held a 'low level duty of care' which required 'not to make a negligent misstatement' or 'to use reasonable care not to recommend a highly risky investment'.[1346] This concept of low level of a duty of care was aligned with the duty not to carelessly mistake facts, acknowledged earlier in *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera*;[1347] which has been adopted in other descendent cases.[1348]

[1343] [2014] EWHC 3043 (Ch)
[1344] *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm)
[1345] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186
[1346] Ibid [108]
[1347] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518 p573

5.1.1.3 Negligent misrepresentation

Negligent misrepresentation[1349] is another major concern in claims of 'mis-selling' of over-the-counter derivatives. Before examining individual cases, it is necessary to understand the legal concept of misrepresentation, which forms the baseline in court's decisions in disputes of over-the-counter derivatives. Misrepresentation comprises some necessary components. First, it should be a representation about facts rather than opinions.[1350] Second, it should be false[1351]— mere lack of clarity or ambiguity doesn't constitute misrepresentation.[1352] Third, an omission of explanation isn't usually deemed misrepresentation.[1353] Lastly, the representation must have induced the consumer to do the transaction.[1354]

The allegations of misrepresentation in the 'mis-selling' of over-the-counter derivatives can be classified into three areas: market prediction, explanation of risks, and disclosure of fees. Each of these areas is discussed below.

Market prediction

Financial institutions' mis-prediction of the underlying asset price is one of the major causes for misrepresentation claims in over-the-counter derivatives transactions. Here, the court's position has been that it doesn't recognize any liability from wrong market prediction in hindsight.

[1348] *Bank Leumi (UK) plc v Wachner [2011] EWHC 656 (Comm)* [196], [197]; *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch) [81] ; *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661 [82]; *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430 [125]

[1349] There are two legal grounds for alleging negligent misrepresentation: misrepresentation in tort and misrepresentation under the Misrepresentation Act 1967. In common law, *Hedley Byrne v Heller*[1349] first introduced negligent misrepresentation, while subsequent cases set up the principles thereof.[1349] The claim based on The Misrepresentation Act 1967 differs only in two aspects from what is required in tort: (1) it has no need for the existence of a duty of care, which is necessary in the tort misrepresentation; and (2) the burden of proof, once misrepresentation is accepted, is shifted to the defendant who should prove that 'he had reasonable ground to believe…the facts represented were true'; see Misrepresentation Act 1967, s.2; Gerard McMeel and John Virgo (n 1354) para 6.18

[1350] The Law Commission and the Scottish Law Commission, *A joint consultation paper: Consumer Redress for Misleading and Aggressive Practice (*Law Com No 199, 2011) para 5.11-5.12

[1351] Ibid, para 5.10

[1352] Ibid

[1353] Ibid, para 5.13

[1354] Gerard McMeel and John Virgo, *Financial Advice and Financial Products (*3rd ed, OXFORD, 2014) para 6.06

First, the contractual term stating 'no representation' and 'no reliance' led the court to adjudicate no misrepresentation. In *JP Morgan Chase Bank and Others v Springwell Navigation Corporation,*[1355] the claimant bought notes referenced to the bonds issued by the Russian Federation, which were embedded with currency forward contracts from JP Morgan. However, the referenced Russian bonds were defaulted upon and the claimant suffered a loss. According to the claimant, JP Morgan made misrepresentations that the Russian economy was strong and that there would be no default on Russia's debt obligations. Note that the contract between the two parties stipulated that 'no representation or warranty expressed or implied was made by CMB [the bank], and conversely, Springwell… represented that…it had independently… made a decision…'[1356]

The court explained that the statement about the Russian economy was the salesperson's opinion rather than a factual comment, which didn't constitute 'misrepresentation'. It adjudicated that, regardless of whether this was an opinion or a factual statement, the contract denied CMB's representation, and therefore barred the consumer from pursuing allegations of misrepresentation. The court analysed the record of conversations between the two parties and found that the claimant still believed that the fundamentals of the Russian economy was not strong, and was therefore not influenced by the alleged misrepresentation—which was therefore not actionable. In other cases, the contractual terms stating non-representation and non-reliance prevented consumers from arguing misrepresentation. Examples include *Grant Estates Limited v The Royal Bank of Scotland Plc*,[1357] where the claimant alleged 'misrepresentation' by the bank about rising interest rates, contrary to the dramatic subsequent decline, and *Standard Chartered Bank v Ceylon Petroleum Corporation*[1358] where the consumer alleged to be misled by the 'misrepresentation' that the oil-related over-the-counter derivatives were for hedge when they were actually very speculative.

[1355] [2008] EWHC 1186
[1356] Ibid [670]
[1357] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133
[1358] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)

Second, the court concluded that a financial institution didn't hold any duty to explain or brief all available market expectations. In *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera*,[1359] the salesperson relayed to the customer a forecast on US LIBOR made by one of economists. This forecast was one of the lowest among many other market experts' opinions. A lower US LIBOR meant that the swap recommended by the financial institution would be more profitable to the customer at maturity. The court ruled that the provision of the lowest forecast of US LIBOR couldn't be a cause for complaint; the forecast didn't purport to represent the forecasts of economists as a whole, and the relatively low forecast compared with those of the majority of other economists didn't mean that it was unreasonable. The court also added the financial institution was not asked to give the general market forecast by the claimant and had no duty to do so.

Explanation of risks

Another claim of misrepresentation is that financial institutions didn't explain or even hid critical risk factors. A related private law principle is again contractual estoppel. The court's primary position is to respect the contractual provisions, excluding any liability of representation. *Peekay Intermark Ltd and another v Australia and New Zealand Banking Group Ltd* provides an obvious example.[1360] The consumer was misled by oral explanation saying that the recommended product would be Russian government bonds, while not clarifying that it was a financial derivative. The claimant made the investment decision based on the wrong oral explanation, but the bank sent a contractual document containing the true product characteristics. The consumer returned a signed document, which included disclaimer[1361] provisions, to the bank without reading it.

[1359] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518

[1360] [2006] EWCA 386

[1361] Ibid [55], which stated "*You should also ensure that you fully understand the nature of the transaction and contractual relationship into which you are entering… The issuer assumes that the customer is aware of the risks and practices described herein, and that prior to each transaction the customer has determined that such transaction is suitable for him*."

While the trial court upheld the claim of misrepresentation, the court of appeal rejected it, emphasizing that the signed contract bound her and estopped from asserting that she was induced to enter into the contract by pre-contractual statements.

An incorrect factual explanation about over-the-counter derivatives is an actionable misrepresentation only when it influences the consumer's decision of entering into the contract. In *JP Morgan Chase Bank and Others v Springwell Navigation Corporation*, the court accepted that JP Morgan made a factually wrong representation in terms of Ukraine bonds, namely that Ukraine had no foreign debt at that time. However, it didn't hold that that misrepresentation was actionable, because it judged that the claimant was not induced to enter into the transaction by misrepresentation.[1362] The analysis of telephone conversations between the parties convinced the court that the consumer was attracted to the Ukraine bond because of its potentially high yield and decent price, and that he would still have invested in the bond even if he had been informed of the exact amount of Ukraine foreign debt.

The decision that an actionable misrepresentation needs actual inducement is also found in *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera*[1363]. The consumer entered into an interest rate swap with the financial institution, which didn't explain that unlimited loss would occur if the US LIBOR became higher than a certain level, while it highlighted the advantages. The court distinguished the question of existence of misrepresentation from whether the client was misled by the misrepresentation, and judged the consumer could demand damages only when misled.

In recent litigation of IRHPs, the 'inducement' ingredient of the 'misrepresentation' about the cost that would occur when terminating the swap contract before maturity was raised. In *John Green and Paul Rowley v The Royal Bank of Scotland Plc*,[1364] the bank explained to the consumer, before entering into the 10-year matured interest rate swap in 2005, that 'there could be a cost or a benefit to the customer depending on market

[1362] [2008] EWHC 1186 [715]-[723]
[1363] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[1364] *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661

conditions' in case of termination. When realizing the termination cost was £138,650 (27.7% of the debt principal) in 2009, the consumer claimed that the bank's explanation was a negligent mis-statement. However, the court rejected this claim; it was not likely to the court that even detailed information about the termination cost would have prevented the consumer from entering into the swap.'

The court determined that financial institutions didn't have any duty to make sure that the consumer understood the meaning of its representation. In another case related to IRHPs,[1365] over-hedge became the disputed issue. The bank sold a 10-year matured swap to a SME for hedging a five-year matured loan with no renewal guarantee. It sent an e-mail mentioning that the swap had 'a 10-year commitment and the bank only has a financing commitment for 5 years.'[1366] The court stated that the bank's explanation of over-hedge in maturity was 'brief but not inaccurate or misleading'. It reasoned that the bank didn't have a duty to 'take adequate steps to ensure the consumer had an adequate understanding of the full range'.[1367]

Disclosure of costs

Undisclosed costs are another frequently raised claim of misrepresentation. It has been market practice for financial institutions to earn their commission through the bid-ask spread rather than to charge its commission separately.[1368] When consumers are not informed of the charged commission by bid-ask spread and learn about it later, they are likely to allege that the non-disclosed commission is misrepresentation. However, private law doesn't recognize the seller's legal obligation to disclose negative mark-to-market value to the counterparty.

The first litigation with a claim against non-disclosed negative value of over-the-counter derivatives was *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera*.[1369] In relation to two interest rate swaps worth $50 million transacted with Dharmala, the

[1365] *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch)
[1366] Ibid [161]
[1367] Ibid [156]
[1368] See n380
[1369] [1996] C.L.C. 518

financial institution charged $10 million through the uninformed negative mark-to-market value. The court concluded that the financial institution was not obliged to disclose the mark-to-market value without any positive representation or undertakings to inform.[1370]

The issue of the non-disclosed negative mark-to-market occurred again in recent IRHP scandals. Nextia Properties entered into a swap with a bank in 2008.[1371] The bank's salesperson suggested to Nextia three alternatives for hedging: a swap, a cap and a collar.[1372] The salesperson explained that there was an upfront payment premium for the cap and collar £50,330 and £5,062 respectively, but stressed that the swap had no cost or fee. The consumer selected the swap, attracted by the 'no cost' condition. However, the mark-to-market value of the swap on the day of execution was negative £89,500 to the consumer, and positive to the bank by the same amount. The consumer bought the swap without knowing the negative mark-to-market value. Referring to the above *Bankers Trust International v Dharmala*, the court ruled that there was no obligation to disclose mark-to-market value.

5.1.1.4 Regulation in private law

Reference to statutory regulation

In general, private law accepts statutory regulation as a criterion in deciding whether a financial institution exercises appropriate 'skill and care' when doing business.[1373] In *Shore v Sedgwick Financial Services Ltd*, the court stated that regulatory requirements could be the start in determining the extent of duty of financial institutions.[1374] Non-compliance with relevant regulatory rules could be seen as a failure of exercising proper

[1370] Ibid p554
[1371] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167
[1372] For the consumer, the swap was a fixed interest rate in exchange for a floating base rate; with the cap set the maximum rate and the collar provided an interest rate band. The cap and collar provided benefits to the consumer, in that the low interest rate would be enjoyed in case of decline, with protection against a rising rate.
[1373] Alaistar Hudson, *THE LAW OF FINANCE* (n 413) location 26623 (Kindle edition)
[1374] [2008] PNLR 244 [161]

'skill and care'.[1375] However, the court doesn't allow the regulation to override private law when requirements are contradictory.

In *Green & Rowley v Royal Bank of Scotland Plc*, the court stated that regulatory requirements related to the provision of advisory service could be applied to the advisory relationship;[1376] however, those rules couldn't be applied outside of an advisory relationship.[1377]

In terms of representation, the statutory regulation requires financial institutions to take reasonable steps to communicate fairly and clearly.[1378] However, in *Green & Rowley v Royal Bank of Scotland Plc*, the court expressly stated that this communication duty was beyond the common law duty of representation, which was 'not to mis-state', and thus rejected the claim that this regulatory requirement was encompassed in the common law duty.[1379]

Right of action of private person

FSMA 2000 expressly entitles a 'private person' with a 'right of action' for losses as a result of financial institutions' breach of regulation.[1380] The Financial Services and Markets Act 2000 (Right of Action) Regulations 2001[1381] defines, the 'private person' as 'any individual' and 'any person who isn't an individual, unless he suffers the loss in question in the course of carrying on business of any kind'.[1382] A 'rule' here refers to the regulations created by financial authorities; the COBS is one such 'rule'. This means that a private person, who suffered losses from financial institutions' breach of the COBS, can demonstrate such breach in court[1383] instead of relying on the breach of common law

[1375] *Loosemore v Financial Concepts* [2001] Lloyd's Rep PN 235, 241
[1376] [2012] EWHC 3661 [82]
[1377] Ibid [109]
[1378] FCA Handbook, COBS 4.2
[1379] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661 [82]
[1380] FSMA 2000, s138D (2)
[1381] FSMA 2000, s138D (6)
[1382] Financial Services and Markets Act 2000 (Right of Action) Regulations 2001, 2001 No.2256, s3
[1383] Nevertheless, it doesn't limit the action of a person from the other common law cause.

duty [1384] —even though it doesn't imply automatic capability of giving rise to compensation[1385].

Titan Steel Wheels Ltd v The Royal Bank of Scotland Plc[1386] was the first case among over-the-counter derivatives disputes, where a non-individual consumer claimed the 'right of action'. In the interpretation of the phrase of 'in the course of carrying on business of any kind', Titan claimed that the currency swaps it entered into were 'merely sporadic and intermittent activity fully outside the course of its business'.[1387] However, the court ruled that Titan entered into the swap in the course of business, and was therefore not a 'private person'. It explained that the word 'any kind' itself expressly indicated the broad meaning of business; even without this the currency swaps were contracted in the course of Titan's business, where it had to hedge the currency rate risk regularly. The court further pointed out that Titan entered into the currency swap, if partly, in expecting speculative profit, and that this speculative motive showed that the swap deals were done in the course of business.

After the Titan case, all claims of status by some non-individual consumers as a 'private person' failed. While this negative result for consumers isn't surprising because of the clear definition of a 'private person', it is helpful to consider some other cases. In *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd*, the plaintiff was a paper company with a sole individual beneficiary.[1388] The beneficiary—a 'private person'—communicated with the financial institution and made the investment; however, the contractor was the paper company, and therefore excluded as 'private person'. Concerning IRHPs, some small and unsophisticated companies also claimed the status of

[1384] Andrew Davis, '*Halsbury's Statutes*' (2013) available at <https://www.lexisnexis.com/uk/legal/results/enhdocview.do?docLinkInd=true&ersKey=23_T23647453338&format=GNBFULL&startDocNo=0&resultsUrlKey=0_T23647459875&backKey=20_T23647459876&csi=282943&docNo=3> accessed 9 March 2016

[1385] Department of Trade and Industry, 'Defining the private investor: a consultative document' para 2.1; *R v Financial Services Authority* [2011] EWHC 999 (Admin) [71]

[1386] [2010] EWHC 211

[1387] Ibid [44]-[76]

[1388] [2011] EWHC 479 (Comm)

'private person', but were rejected because their legal entity was non-individual.[1389] Based on the above cases, it is difficult to avoid the criticism that the definition of private person in Section 138D of FSMA 2000 is too cursory, because paper companies and small SMEs—which are in reality as unsophisticated as individual persons—are classified as non-private persons merely by their type of legal entity.

Application of regulatory rules for private person

The previous section indicated who is entitled to the statutory 'right of action' from breach of regulatory duties. This section examines how private law deals with alleged 'mis-selling' of over-the-counter derivatives related to a private person with the 'right of action'.

(1) Meaning of 'right of action'

Even though the 'right of action' itself doesn't automatically give rise to compensation,[1390] a loss-causing contravention is likely to result in a compensation order even without breach of common law duties. In *Morgan Stanley UK Group v Puglisi Cosentino*,[1391] the court found a contravention of then regulatory rules, including the breach of suitability and risk warning rules, and accepted that the breach had caused the consumer's loss. Though the court indicated that the consumer's claim for misrepresentation by common law was not successful,[1392] it held for the consumer based on the contravention of regulatory rules.

In two other cases,[1393] where the consumers as private persons claimed compensation based on the 'right of action', the court showed the will to make decisions based on regulatory rules without relying on private law.

[1389] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133; *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167 (QB); *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430

[1390] See n1385

[1391] [1998] C.L.C. 481

[1392] Ibid p500

[1393] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM); *Zaki & others v Credit Suisse (UK) Limited* [2012] EWCA Civ 583; *Basma Al Sulaiman v Credit Suisse Securities (Europe) Limited, Plurimi Capital LLP* [2013] EWHC 400 (Comm)

(2) The court's proactive approach

The court has developed its own proactive approach in applying regulatory rules to the case of a private person—*Zaki & others v Credit Suisse (UK) Limited* serves as a good example.[1394]

(3) The court's own approach to the suitability rule

Credit Suisse's (CS) account manager failed to gather the necessary consumer information for recommending suitable products. In the recorded form, the consumer's investment objectives were not clear, and his net worth varied from £ 100 million to £ 250 million. The court acknowledged that CS lacked rigor and care in obtaining consumer information, thus breaching the COBS suitability rule.

The latter requires financial institutions to recommend suitable products, and to follow the specified 'reasonable steps' to ensure suitability. In other words, COBS requires certain procedures to ensure that suitable advice is provided. Specifically, regardless of whether or not a personal recommendation was suitable, neglect by a financial institution to follow the reasonable steps stipulated in the COBS constitutes a breach.[1395]

However, the court stated that regulatory failure in securing the client's information for suitable recommendation didn't prove that the recommendation was not suitable. In its reasoning, the court was focused on the suitability itself rather than on compliance with procedural rules in ensuring suitability.[1396] The court's focus on substance rather than

[1394] In this case, the consumer bought 10 structured notes from Credit Suisse (UK) Limited ("CS") from 2007 to 2008. All of these notes were linked with performance of market indices or individual stocks, and if the linked stock market benchmark is above a "strike price" at the maturity of a note, the note can make an enhanced return to the holder, but if the benchmark has ever touched the barrier level (e.g. 55% of strike price), the note will be redeemed at the final level of the worst performing benchmark. After suffering a huge loss from these derivative-embedded products due to the global financial crisis in 2008, the claimant argued that CS breached the suitability rule of COBS during the process of the notes sales. There was no dispute about the status of the consumer as a "private person" because he was an individual person. The court judged whether or not there was breach of COBS and made its final ruling based on COBS and not on common law standards.

[1395] FCA Handbook, SYSC 9.1.1R

[1396] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM) [99]; the court explained that: "The important point, it seems to me, is whether the recommendations made by Mr. Zaki [salesperson] were suitable for Mr. Zeid [consumer]. If they were not suitable then it adds nothing to enquire whether Mr. Zaki's approach to obtaining and recording information and classifying the Claimants lacked the required rigour and care. If they were suitable, then again it cannot matter whether his approach to obtaining and recording

procedures in suitability was well revealed in its investigation on consumer's risk appetite.[1397]

(4) The court's interpretation of suitability

Zaki & others v Credit Suisse (UK) Limited[1398] further emphasized the court's proactivity in interpreting regulatory rules. In reviewing the suitability of CS's recommendation, the court investigated not only those three components expressed in COBS, but also investment diversity[1399] and market conditions;[1400] the court took investment diversity and the turbulent 2008 market conditions into account for adjudication on suitability, even though the COBS didn't require a financial institution to consider market conditions when recommending financial products.[1401]

5.1.1.5 Causation

One of the tort law principles is that, for compensation, the claimant should prove that the defendant's wrongdoing caused the damage: 'no proof of causation, no compensation'.**[1402]** Causation in tort requires two types of causation: factual and legal

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information and classification was adequate or not… In that sense regulatory failures in the information gathering exercise may evidence a breach of the duty to take reasonable steps to ensure that the recommendations were suitable but they don't, it seems to me, assist in showing that the recommendations were not suitable."

[1397] The internal record of CS described the consumer's risk tolerance was "moderate", which was, as the compliance department of CS had stated internally, not compatible with the risk profile of the recommended products. However, the court put more weight on the consumer's prior investment experience in similar non-capital protected products and concluded that 'it doesn't follow that the 10 structured products which form the basis of this claim should be regarded as carrying a risk greater than that which Mr. Zeid [consumer] had been prepared to accept and which Mr. Zaki [salesperson] described in the suitability forms as "moderate"'.

[1398] Ibid

[1399] EWHC 2422 (COMM) [120]

[1400] Ibid [126]

[1401] The COBS subdivides suitability into three components: 'investment objectives', 'capability of bearing risk' and 'experience and knowledge' of the consumer. The court stated that the diversity in investments should be one of the elements when assessing the suitability of the recommendation, even though the COBS didn't contain any explicit requirements about diversity. The court adjudicated that structured notes bought in 2008 were not suitable to the consumer, considering ominous market conditions with some harbingers of a dreadful global financial crisis. The court stated that 'notwithstanding Mr. Zeid's [the consumer] appreciation of the risks and his ability to bear the consequences of them materializing, the line had been crossed in May/June 2008.'

[1402] Sandy Steel, *Proof of Causation in Tort Law* (Cambridge University Press 2015) 1

causation.[1403] Factual causation requires wrongdoing as the necessary condition for the occurrence of the claimant's harm, and requires proof that without the wrongdoing the harm would not have occurred—the so-called 'but for' test.[1404] Legal causation means that the harm should be foreseeable at the time of the action.[1405] While the wrongdoing satisfies the 'but for' test, that is, factual causation, causation isn't proved if it is remote to the harm.

This legal concept of causation is applied not only to the tort of 'mis-selling', but also to cases brought by the statutory 'right of action'. Section 138D of FSMA 2000 provides a private person who suffers loss *as a result of* the contravention of the COBS with the 'right of action' in damages. The phrase 'as a result' is the requirement of causation, and the above causation principles in tort are also applied.[1406]

Factual causation

To investigate factual causation, the court checks the consumer's reliance on the financial institution's unsuitable advice. The consumer's reliance on unsuitable advice when deciding to enter into an over-the-counter derivatives contract, could prove that he would not have entered the contract 'but for' the advice.

In *Zaki & others v Credit Suisse (UK) Limited,*[1407] where the court found some unsuitable recommendation as breach of the COBS, the court recognized that the consumer followed the salesperson's advice in some cases but denied the consumer's reliance in some other purchases on advices, stating that he made his own investment decisions after familiarisation with non-capital protected notes. The court concluded that, even without advice, he would still have bought them and suffered loss since his investment

[1403] Kirsty Horsey and Erika Rackley *Tort Law* (Oxford 2013) 224-255
[1404] Ibid p225
[1405] Ibid p247
[1406] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184 [45]; George Walker, Robert Purves and Michael Blair (n439) para 7-30
[1407] [2011] EWHC 2422 (COMM)

decision was based on his own view of the markets. There was therefore no causal link between the unsuitable recommendation and the loss.[1408]

A subsequent question then arises: under what circumstances could factual causation between the breach and the loss be achieved? *Adrian Rubenstein v HSBC Bank*[1409] provides a clue to the answer.[1410] In this case, the claimant, an individual person, asked HSBC for a safe investment without any risk of capital loss; the bank recommended a fund, explaining that it was as safe as a bank deposit. His simple investment objective was temporary and secure saving of proceedings from his home sale until the purchase of a new home. However, the fund was not as safe as a bank deposit. The 2008 global financial crisis resulted in a substantial loss to the consumer. The trial court admitted that HSBC breached the COBS by recommending an unsuitable product, and accepted the plaintiff's reliance on the bank's recommendation. The court explained that the consumer 'was willing to invest his money in whatever Mr. Marsden [the salesperson] recommended',[1411] and admitted that he would not have invested in the fund if the bank had not recommended it.

In summarizing the factual causation requirements from the above cases, entire reliance on advice, that is, the attitude of following advice regardless, can pass the 'but for' test; however, partial reliance, where the consumer from his own perspectives makes an investment decision informed by the advice, cannot pass the test.

Legal causation

When unsuitable advice or misrepresentation is found to be a necessary condition of the consumer's loss (factual causation), the next step in proving causation is to determine if the unsuitable advice was remote to the loss (legal causation).

In *Adrian Rubenstein v HSBC Bank*, the trial court investigated legal causation after accepting factual causation. It reasoned that the consumer's loss was not caused by the

[1408] The salesperson's testimony that the consumer relied on his advice in making investment decisions was insufficient evidence for factual causation.
[1409] [2011] EWHC 2304
[1410] However, it was not related with over-the-counter derivatives.
[1411] Ibid [108]

structure of the recommended investment product, but by the evaporated market liquidity amid the 2008 global financial crisis.[1412] Based on this reasoning, the court concluded that the loss was not foreseeable at the time of recommendation, and legal causation was not accepted. However, this denial was repealed at the court of appeal,[1413] which explained that the claimant tried to avoid market risk, while the bank recommended a product with foreseeable risk and so ruled the bank's unsuitable recommendation as cause of the loss.

Two points can be inferred from the above decisions. First, unless the consumer expresses the desire to avoid market risk, it may be impossible to prove that legal causation of the unsuitable advice to loss partly resulted from market turmoil, considering the fact that the court of appeal accepted the legal causation based on the consumer's expressed intolerance of market risk.

Second, these two cases with different results about legal causation show causal uncertainty due to 'multiplicity of possible causes'.[1414] When there are two possible causes for a consumer's loss, such as unsuitable advice and unexpected market movements, there is uncertainty in finding the 'true' cause.[1415] Uncertainty of how the courts will reason in the causation test should be also pointed out. In the above cases, such as *Adrian Rubenstein v HSBC Bank* and *Zaki & others v Credit Suisse (UK) Limited,* the courts imposed tight criteria of proof of causation on the claimants. However, in *Morgan Stanley UK Group v Puglisi Cosentino,* for example, the court ruled that the financial institution breached the suitability rule of then statutory regulation, and accepted the causality, without strict reasoning.[1416]

[1412] Ibid [113]-[115]

[1413] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184

[1414] Sandy Steel (n1402) 8

[1415] Ibid

[1416] [1998] C.L.C. 481, p499; the court said that "[i]t seems to me that the onus of proof of breach of statutory duty is on Mr Puglisi [consumer] and in relation to r. 730 he must also show that he relied on the advice given. In my judgment he did rely on that advice — indeed it would be absurd to suppose otherwise since without the recommendation of PERLS by Mr Revelli [sales person] he would never have entered the PERLS transactions or, indeed, heard of PERLS at all. I don't think he has to go further and show what he would have done if he had received the correct advice, but, if he had received proper advice, he would in fact not have invested in PERLS."

5.1.1.6 Summary of private law

This chapter explored private law's approach to disputes of 'mis-selling' of over-the-counter derivatives. The first conclusion is that the court prioritises contractual terms when imposing duties on parties of the transaction. When the transaction's reality differs from the contract, the court follows the right and duty defined by the contract. The courts' decisions support the contract-first principle that relationship-defining clauses (such as 'execution-only', 'no advisory service') and disclaimer clauses (such as 'no representation', 'no reliance', and 'no liability') have full legal power, regardless of the transactions' reality.

Second, the court has a stance that regulatory requirements can inform but not override private law. For example, once an advisory relationship is accepted in private law, the regulatory requirements on financial advisors can be embraced in private law standards. However, these requirements cannot be referred to in the 'execution-only' relationship; the regulatory requirement of fair and clear communication on financial institutions is rejected in private law, because the requirement is beyond private law's 'duty not to mis-state'.

Third, the court is proactive in applying regulatory requirements to civil cases brought by the 'right of action'. While the 'right of action' doesn't bind the court's decision, it seems willing to adjudicate based on the regulatory requirements alone, without considering private law principles. In interpreting regulatory requirements, the court showed its capability and willingness to develop its own interpretation and standards related to regulatory requirements. Even though some of the court's interpretations of the COBS—such as adding 'market condition' to factors considered for suitability—are controversial, the court's proactive attempt to interpret regulatory requirements is desirable for the progressive development of private law.

Lastly, this chapter considered the causation test in private law, consisting of factual and legal causation. The cases showed that proving causation presents consumers with a

significant obstacle. For factual causation, it is difficult to prove the hypothetical assertion that the consumer would have acted differently without the breach of the financial institution. For legal causation, the usual existence of at least two causes for loss—such as breach of the financial institution and unexpected market turmoil—makes it difficult for the consumer to single out breach as the real cause.

Integrating all of these aspects and modalities of reasoning indicate a limited prospect of success for consumers in obtaining compensation under private law. These low prospects are verified by 18 cases[1417] of 'mis-selling' of over-the-counter derivatives; only one[1418] out of 15 consumers (18 cases) succeeded in obtaining a redress order in court (see Table 3). The first reason for this low success rate is that it isn't probable for private law to accept negligent advice or misrepresentation, considering the standard forms of over-the-counter derivatives contracts, which include various 'exclusion clauses'.[1419] Among 13 cases[1420] where consumers alleged negligent advice or misrepresentation in tort, breach of private law standards was not accepted in any one.

The FSMA 2000 'right of action' for breach of regulatory duty improves consumers' chances of success, but is limited to 'private persons'. Five corporate consumers[1421] were denied the status of 'private persons' and had no statutory 'right of action'. Two[1422] out of three 'private persons'[1423] succeeded to obtain the court's ruling that there were statutory breaches by financial institutions. The causation test presents the last obstacle

[1417] The 18 cases were chosen through Westlaw as following criteria: 1) cases including the words of "derivatives", "advice" and "duty of care" or "misrepresentation"; and 2) cases where consumers alleged "negligent advice" or "misrepresentation" or regulatory breach of financial institutions; and 3) cases adjudicated before 31st December 2015

[1418] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481

[1419] Iain G Mitchell QC, 'Written evidence from Iain G Mitchell QC' (Parliamentary business, 2012) <http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27v_we17.htm> accessed 18 March 2016

[1420] Cases which have "Y" or "N" in the column of "Applied by private law" in the Table 3 at p251

[1421] Cases which have "N" in the column of "Private person" in the Table 3 at p251

[1422] Cases which have "Y" in the column of "Breach of suitability" or "Breach of communication rule" in the Table 3 at p251

[1423] Cases which have "Y" in the column of "Private person" in Table 3 at p251

for consumers. Only one[1424] out of two consumers who obtained the ruling of regulatory breach succeeded in proving causation and securing a compensation order.

[1424] The case which has "Y" in the column of "Causation" in the Table 3 at p251

Table 3: Summary of cases[1425] related with 'mis-selling' of over-the-counter derivatives between financial institutions and consumers

Cases (Name of consumer)	Adjudication Year	Applied by private law			Applied by regulatory rules			Causation
		Existence of advice	Negligent advice	Misrepresentation	Private person	Breach of suitability	Breach of communication rule	
Dharmala[1426]	1995	N 1)	N	N	-	-	-	N
Puglisi[1427]	1998	-	-	N	Y	Y	Y	Y
Peekay[1428]	2006	-	-	N	-	-	-	-
Springwell[1429]	2008	N	N	N	-	-		N
Titan[1430]	2010	N	N	-	N	-	-	-
Wachner[1431]	2011	N	N	N	-	-	-	N
Ceylon[1432]	2011	N	N	N	-	-	-	-
Zaki[1433]	2011,	-	-	-	Y	Y	-	N
Camerata[1434]	2011, 2012	Y	N	-	N	-	-	-

[1425] See n1417
[1426] *Bankers Trust International plc v PT Dharmala Sakti Sejahtera* [1996] C.L.C. 518
[1427] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481
[1428] *Peekay Intermark Ltd and another v Australia and New Zealand Banking Group Ltd* [2006] EWCA 386
[1429] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186
[1430] *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211
[1431] *Bank Leumi (UK) plc v Wachner* [2011] EWHC 656 (Comm)
[1432] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)
[1433] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583

Cases (Name of consumer)	Adjudication Year	Applied by private law			Applied by regulatory rules			Causation
		Existence of advice	Negligent advice	Misrepresentation	Private person	Breach of suitability	Breach of communication rule	
Grant[1435]	2012	N	N	N	N	-	-	-
BAS[1436]	2013	-	-	-	Y	N	N	N
Nextia[1437]	2013	-	-	N	N	-	-	-
Green[1438]	2012, 2013	N	N	N	-	-	-	N
Crestsign[1439]	2014	N	Y 2)	N	-	-	-	-
Thornbridge[1440]	2015	N	N	N	N	-	-	N

1) Court adjudication: Y (held), N (not held), - (not discussed)

2) Negligent advice but not actionable due to the disclaimer of providing advice

[1434] *Camerata Property Inc. v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm) 2011 WL 674989 (for 'Appplied by private law' in the Table 3); [2012] EWHC 7 (Comm) 2012 WL 14689 (for 'Applied by regulatory rules' in the Table 3)

[1435] *Grant Estates Limited v The Royal Bank of Scotland Plc* [2012] CSOH 133

[1436] *Basma Al Sulaiman v Credit Suisse Securities (Europe) Limited, Plurimi Capital LLP* [2013] EWHC 400 (Comm)

[1437] *Nextia Properties Limited v National Westminster Bank plc and The Royal Bank of Scotland plc* [2013] EWHC 3167 (QB)

[1438] *John Green and Paul Rowley v The Royal Bank of Scotland Plc* [2012] EWHC 3661; [2013] EWCA Civ 1197

[1439] *Crestsign Ltd v National Westminster Bank plc and Royal Bank of Scotland plc* [2014] EWHC 3043 (Ch)

[1440] *Thornbridge Limited v Barclays Bank Plc* [2015] EWHC 3430

5.1.2 Dissonance between private law and regulation in the UK

This section seeks diverging principles and requirements of private law and regulation in dealing with 'mis-selling' of over-the-counter derivatives. This requires comparison of duties placed on the same activities of financial institutions in over-the-counter derivatives transactions by private law and regulation. The different approaches of the two institutions to the same activities and issues are illustrated.

5.1.2.1 Different duties of the same activities

The two most disputed activities in over-the-counter derivatives transactions are: what product is recommended, and how is the recommendation communicated. Private law and regulation have their own principles and requirements for these activities. First, concerning product recommendation, the criteria for defining an advisory relationship differ. Second, in recommending a product, private law usually places a 'low level duty of care' on financial institutions, while regulation demands standards such as 'suitability' or 'appropriateness', which are judged against more demanding criteria. Concerning communication, private law applies principles of misrepresentation, while the 'fair communication' rule is applied in regulation. The relevant principles and rules of the two institutions are compared below.

Duties on recommending a product

In both private law and regulation, the question of whether the financial institution has an advisory relationship with the consumer is critical to the definition of its obligations in recommending a product. In private law, an advisor has more onerous obligations[1441] than an execution-only service provider, and an advisor is required in regulation to ensure 'suitability' of advice; this duty isn't demanded from an execution-only service provider. However, the definition of an advisory relationship by the two institutions is quite different. Before comparing duties in recommending, the differences in defining the relationship first need to be compared.

(a) Existence of advice

[1441] See section 5.1.1.2

The court prioritises contractual terms when deciding on the existence of 'advice'.[1442] Absence of contractual terms about advisory services could be evidence of no advisory relationship, and a disclaimer from providing advisory service leads to no advisory relationship, regardless of the factual relationship.[1443] In contrast, regulation focuses on the actual relationship between the financial institution and the consumer, rather than on contractual terms.

The precedent European Union financial regulator, the Committee of European Securities Regulators[1444] (CESR), provided criteria for deciding the existence of an advisory service based on the actual relationship.[1445] As example, application of these criteria to *Titan*

[1442] See n1329

[1443] See n1330-n1337

[1444] The CESR is the predecessor of the current European Union financial regulatory institution, the European Securities and Markets Authority (ESMA), which has replaced the CESR in 2011

[1445] Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (2010, Ref. CESR/10-293). This Q&A is a practical convergence tool used to promote common supervisory approaches and practices under Article 29 (2) of the ESMA Regulation, therefore competent authorities in member states are to follow this Q&A. This criterion is a practical convergence tool used to promote common supervisory approaches in member states and, therefore competent authorities in member states are to follow this. A close look at this criterion helps to understand the regulatory approach on this issue. The CESR suggested 'the five key tests for investment advice' to determine whether services of a financial institution constitute investment advice. All the five key tests should be met for a service offered to be recognized as advice. The first test among the five key tests is whether the service offered constitutes a recommendation. A recommendation is a course of action such as buying, selling and holding a financial instrument whereas giving information is statements of fact or figures. Therefore, simply giving information without suggesting a specific action of the client isn't advice. The second test is whether the recommendation is in relation to one or more transactions in financial instruments. Investment advice should relate to a particular financial instrument, so generic advice about a type of financial instrument such as investment in a geographical zone or a manufacturing industry in a stock market doesn't constitute investment advice. A general recommendation which is a recommendation intended for distribution channel or the public is also not investment advice. The third test has two questions. When only one is met, the third test is qualified. One of the two questions is 'whether the recommendation is presented as suitable'. A recommendation stating a financial instrument as suitable explicitly or implicitly for the investor constitutes advice. It should be noted that an implicit statement like 'people like you tend to buy this product' as well as an explicit promotion like 'this product is the best option for you' are all seen as advice. The CESR also describes that even a clear disclaimer by a financial institution stating that no advice is being given cannot change the nature of the communication as investment advice. The other question in the third test is whether 'the recommendation is based on a consideration of a person's circumstances'. Circumstances here means the information about the client's financial status, long-term and short-term financial objectives and risk appetite, for example. Whether or not a financial institution considers its client's circumstances when recommending, the client's perception is the decisive point here. This means that a financial institution is held responsible if it gives the impression that its product recommendation is based on the client's circumstances. In summary, the third test is met if the recommendation is presented as being suitable to the client or is promoted with the impression that it is given on the basis of the client's financial circumstances. The fourth test is whether 'the recommendation is issued otherwise than exclusively through distributional channels or to the public'. The relevant consultation paper specifies newspaper, radio and TV as distributional channels or medium to the public in general. The point

Steel Wheels Ltd v The Royal Bank of Scotland Plc[1446] clearly reveals the divergence between private law and regulation. In this case, the court rejected the existence of advice based on contractual terms, indicating that no advisory service had been provided.[1447] The existence of advice based on the regulatory perspective, by applying CESR's criteria to the case, is discussed below.

The bank's corporate treasury manager sent the Titan financial controller the following e-mail:

> The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement. Importantly, it isn't a hedge. However, this additional trade does give you the opportunity to achieve rates better than what is available in the market by conventional spot or forward contracts. The numbers below are based on a minimum of €0.5m per month and a maximum of €1m per month. The basis for the trade is to provide an enhancement to your existing hedge and to run in conjunction with it.[1448]

1. *Test 1: Does the service offered constitute recommendation?* In this e-mail, sentences such as 'The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement' and 'The basis for the trade is to provide an

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here is whether the client given the recommendation is a particular person or group or unknown people. Investment advice should be a personal recommendation targeted to a particular person or group. The fifth test is whether 'the recommendation is made to a person in his capacity as a (potential) investor or as an agent of a (potential) investor'. This test means that a recommendation given to a person without any capacity of (potential) investor doesn't constitute investment advice. The above criteria expressly state that advisory relationship is decided by the actual communication between financial institutions and consumers, not by contractual terms. This approach was confirmed by the FSA which said that terms excluding advice from the remit of services provided continued to be possible but they couldn't operate to exclude the application of the FSA rules where investment advice was actually given. This response clarifies that the FSA looks at the content of communication when deciding the existence of advice.

[1446] See n1324; [2010] EWHC 211
[1447] See n1338
[1448] *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211 [42]

enhancement to your existing hedge and to run in conjunction with it' are recommendations to buy the product, whether explicit or implicit.

2. *Test 2: Is the recommendation in relation to one or more transactions in financial instruments?* The manager explained the specific condition and terms of the September product, such as 'a minimum of €0.5m per month and a maximum of €1m per month'. This indicates that her recommendation was related to a particular transaction of a financial instrument.

3. *Test 3: Is the recommendation as least one of a) presented as suitable or b) based on a consideration of the person's circumstances?* She pointed out that 'The basis for the trade is to provide an enhancement to your existing hedge and to run in conjunction with it.' This statement indicates the 'suitability' of the new product to Titan's 'existing hedge' products. She also said that 'The idea below gives you the opportunity to outperform the spot and forward rates for your expected EUR requirement.' This indicates that her recommendation was based on her knowledge of Titan's 'expected EUR requirement'—the client's circumstances. In addition, Titan already had a 10-year long business relationship with the bank at that time. Considering business practice, it can be expected that a bank with a 10-year relationship with a consumer[1449] would suggest a financial product based on good knowledge and consideration of its client's financial circumstances and objectives.[1450]

4. *Test 4: Is the recommendation issued otherwise than exclusively through distribution channels or to the public?* This e-mail was sent to Titan's financial controller's personal e-mail account; the recommendations therefore meet this test.

[1449] Titan started currency transactions with the Bank since 1997.

[1450] Committee of European Securities Regulators, 'Questions and Answers: Understanding the definition of advice under MiFID' (n 1445) 13, where "[i]f a firm has accumulated relevant information on a person's circumstances-either during a single interview or during the course of an ongoing relationship-and it can reasonably be expected that this information is being taken into account. In this case, any recommendation made will be treated as being based on a consideration of the person's circumstances. This situation is perhaps most likely to arise if a firm collects potentially relevant information from a client through one contact point, as part of an established relationship. In this situation, the firm could be held responsible for giving the impression that it is basing its later recommendations on information about the person's circumstances collected earlier."

5. *Test 5: Is the recommendation made to a person in his capacity as one of: a (potential) investor or an agent for a (potential) investor?* She recommended the product to Titan's financial controller, who is an investor's agent.

The result of these tests is that the bank's recommendation to Titan was 'advice' from the regulatory perspectives. This is contrary to the court's adjudication of no advisory relationship.[1451] In essence, private law recognizes contract-based advisory relationships, while regulation seeks 'de-facto' reality-based advisory relationships.

(b) Duties in transacting a product

Different criteria were compared above in determining the existence of an advisory relationship. This section considers the different duties of financial institutions when transacting over-the-counter derivatives. Private law and regulation place equally stringent duties on a financial advisor.[1452] However, as standard contract forms disclaim advisory service, it is rare for a financial institution to have the status of advisor in over-the-counter derivatives transactions.[1453] When there is no advisory relationship, private law acknowledges a 'low level duty of care' of financial institutions in over-the-counter derivatives transactions.[1454] Considering the effect of contractual terms in disclaiming advisory service, a 'low level duty of care' is the 'usual' requirement in private law. This duty includes 'not to make a negligent misstatement' and 'to use reasonable care not to recommend a highly risky investment' without warning about the risks.[1455]

On the other hand, regulation requires 'suitability'[1456] within the provision of advisory services, and 'appropriateness'[1457] during an execution-only service. Under the COBS's suitability rule, investment advice should (1) meet the client's investment objectives; (2) be such that the client is able to financially bear the investment risk; and (3) be such that

[1451] See n1324
[1452] See section 5.1.1.2
[1453] Table 1 at p 1 6 3
[1454] See n1346
[1455] Ibid
[1456] FCA Handbook, COBS Chapter 9
[1457] FCA Handbook, COBS Chapter 10

the client has the necessary experience and knowledge in order to understand the investment risk.[1458] The suitability rule demands the financial institution to 'know your clients' first, and then to provide proper advice in line with this knowledge. This rule is absolutely beyond the 'low level duty of care' in private law. Even with the execution-only service, regulation requires financial institutions to assess the 'appropriateness' of the transaction requested by consumers, by assessing whether the consumer has the necessary experience and knowledge to understand the associated risks.[1459] Assessing the consumer's experience and knowledge against the risks of the financial product is also beyond private law's obligation 'not to make a negligent misstatement' or 'to use reasonable care not to recommend a highly risky investment without warning about the risks'.

In *Titan v The Royal Bank of Scotland*,[1460] the court ruled that there was no breach of a duty of care by the bank. In this case, private law didn't accept the advisory relationship, nor breach of duty of care of the financial institution; however, the financial institution seems to have provided advisory service under regulatory perspective, and breached the 'suitability' rule.[1461]

[1458] FCA Handbook, COBS 9.2.2R

[1459] FCA Handbook, COBS 10.2.1R

[1460] See n1324; *Titan Steel Wheels Ltd v The Royal Bank of Scotland plc* [2010] EWHC 211

[1461] Titan was classified as a "professional client" under the COBS. Under the COBS, for a professional client, only the objectives of the transaction should be assessed for suitability because the professional client's capability of bearing the risk from the transaction and sufficient experience and knowledge about the transaction can be assumed. The objectives of Titan to enter into the currency swap was to hedge the euro/sterling currency rate risk when it had to sell euros earned through sales in continental Europe to buy sterling for the expenses in the UK. During the telephone conversation in June 2007, Titan's financial controller made it clear to the Bank's corporate treasury manager that its objective of currency derivatives deals was hedge, by saying 'And, and the one thing I've done is to actually protect it, if it screws, and I think that's the main thing really… I know I'm not going to make a load of money, but I'm trying to save us from losing a lot of money. I don't know if you see what I mean.' The June currency swaps provided Titan with protection from the weakness of euro above the "upper level" currency rate. Even though the amount (€2.0 million per month) it should sell when the euro strengthened below "lower level" was twice to the amount (€4.0 million per month) it was protected above the "upper level", this condition was to provide Titan with better terms for protection. Therefore, the structure of the June currency swap was suitable to Titan's financial objectives, which was to hedge. The volume of the deal was also not beyond the hedge objective. The amount it should sell was €2~4 million per month, annually €24~48 million, which was reasonable from the perspective of hedging, considering Titan's annual turnover, €36.5 million. It means that even when the currency rate moved adversely to Titan in the currency swap (i.e. strengthened euro), the euros that Titan earned from its business could offset most of the losses from this currency swap. This was a hedge. The September currency swap contained

Duties in communication

Private law and regulation have different standards in terms of communication as well: misrepresentation in private law, and the 'fair, clear and not misleading communication' rule[1462] in regulation. The two different duties are compared below.

Private law doesn't see 'opinions' as misrepresentations.[1463] In *JP Morgan Chase Bank v Springwell Navigation*, the claim that the bank misrepresented the state of the Russian economy as being strong just before the country's moratorium was rejected by the court: the comment on the Russian economy was considered an 'opinion', which couldn't constitute misrepresentation.[1464] On the contrary, the regulator penalized excessively rosy or unbalanced market predictions, which resembled 'opinions' of financial institutions. For instance, Chase de Vere Financial Solutions was sanctioned because the regulator determined that the promotional materials of its FTSE 100-connected derivative products, which asserted without proper risk warnings that FTSE 100 would perform well, constituted breach of the 'fair communication' rule.[1465] Santander was also penalized due to its rosy opinions related to the derivatives-embedded investment product.[1466]

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more speculative structures compared with the June product. It would cause loss to Titan when the spot currency rate went down below the "upper level" (called "accrual rate" in the September product), whereas the June product would cause loss to Titan only when the spot rate went down below the "lower level" which was set quite lower than the accrual rate. Additionally, even when the spot rate went up above the "upper level", the profit of Titan was limited by 10 cents per euro. In essence, the September product was a betting on expectation about the narrow movement range of the euro/sterling currency rate. In spite of this speculative product structure, any possible loss from this product could be offset by the strengthened euro that Titan had, but only if Titan had enough euro cash flow. However, Titan already held an exposure of 24~48 million euros in the June product and its annual euro earning was €36 million, so additional exposure to currency swaps on top of the June product would mean an over-hedge. The Bank's account manager should have given attention to this over-hedge because the consumer's objective was to hedge. Titan's financial controller also stated to the Bank's manager that he was 'clearly concerned at the scale of the product' during the telephone conversation before entering into the September product. This comment shows that he was concerned about the over-hedge created by the September product. Considering the speculative feature and over-hedge, under regulation, the September currency swap can be seen unsuitable to Titan whereas the June product seems to be suitable.

[1462] FCA Handbook, COBS 4.2.1R

[1463] See n1350

[1464] See n1355

[1465] See n953

[1466] Ibid

Factually wrong explanations are also rarely seen as a misrepresentation in private law. First, it is because of contractual estoppel from clauses disclaiming representation such as 'no representation' and 'no reliance on representation'.[1467] In *Peekay Intermark v Australia & New Zealand Banking Group*, even though the bank provided factually wrong characteristics of the investment product, the contract stating that the consumer 'fully understands the nature of the transaction' estopped him from asserting misrepresentation.[1468] Second, misrepresentation which actually doesn't induce the claimant to enter into the contract isn't actionable.[1469] In recent litigation related to interest rate hedge products, a financial institution's failure to fully explain termination cost was not accepted as a misrepresentation; the court believed that even a detailed explanation about termination cost would not have changed the consumer's decision to enter into the contract.[1470]

On the contrary, regulation has much stricter requirements on representation, and doesn't acknowledge the effect of contractual disclaimers. The COBS prescribes that financial institutions must not 'exclude or restrict' or 'rely on any exclusion or restriction of' any duty towards a consumer.[1471] Therefore, disclaimers excluding liabilities of misrepresentation cannot prevent the regulator from sanctioning misleading communications. Second, breach of the 'fair communication' rule doesn't depend on whether the consumer is actually induced by the communication. While this rule demands communication not to mislead, the actual consequence of consumers being misled isn't a necessary factor for sanction. For instance, where a financial institution wrongly explained that the Financial Services Compensation Scheme protected the investment principal of a fund, the regulator sanctioned the institution without evidence that consumers were actually induced to buy the product with that false communication.[1472]

[1467] See n1360
[1468] See n1361
[1469] See n1362, n1363
[1470] See n1364
[1471] FCA Handbook, COBS 2.1.2R
[1472] Financial Supervisory Authority, 'FINAL NOTICE to SANTANDER UK PLC' (2012)

Third, the 'fair communication' rule requires not only provision of non-false facts, but also provision of 'suitable' information in a 'suitable' way for the consumer.[1473] This means that the financial institution should consider what information and communication method is suitable for the consumer.[1474] The sanction case of Credit Suisse International is a good example. The institution promoted that its investment product could gain a maximum 50% return, which was theoretically possible and therefore not factually false; however, it was penalized by the regulator's decision that highlighting the maximum return, which had a very low probability of realization, was misleading communication.[1475]

A further difference exists in the obligations in confirming consumers' understanding of explanations by financial institutions. Private law doesn't impose an obligation on the institution to ensure that the consumer understands its explanation. In *Crestsign Ltd v National Westminster Bank Plc and Royal Bank of Scotland Plc*, the court ruled that the financial institution, which transacted a 10 year-maturity interest rate swap for a 5 year-maturity loan with a brief factual explanation, didn't have a duty to 'take adequate steps to ensure the consumer had an adequate understanding of the full range'.[1476] On the contrary, regulation expressly states that financial institutions should 'take reasonable steps' to ensure that their communication is 'fair, clear and not misleading'.[1477] In terms of interest rate hedge products with a longer maturity than the one of the hedged loan, the regulator expressed that financial institutions must 'determine whether it is reasonable to conclude that the customer could have understood the product's features and risks; if not, it constituted non-compliance with regulation.[1478]

The stance towards omission of explanation represents another difference between misrepresentation in private law and the 'fair communication' rule in regulation. In private law, *caveat emptor* is the basic and informing principle, and omission of

[1473] FCA Handbook, COBS 4.2.2G (1)
[1474] Alaistar Hudson, *The Law of Finance* (n413) para 10-19
[1475] See n955
[1476] [2014] EWHC 3043 (Ch)
[1477] FCA Handbook, COBS 4.2.6R
[1478] Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' 12-13 available at < Interest Rate Hedging Products Pilot> accessed 9th January 2019

explanation generally doesn't constitute misrepresentation.[1479] For example, in *Nextia Properties Limited v National Westminster Bank Plc and The Royal Bank of Scotland Plc*, the failure to explain negative mark-to-market value in an interest rate swap was not ruled as a misrepresentation in private law.[1480] On the contrary, the regulator required compensation for the loss from an interest rate swap, in which the information about its negative mark-to-market value was not explained to consumers.[1481]

In summary, private law imposes obligations of merely not stating false facts, while regulation demands that financial institutions attempt to ensure that consumers understand all the material features and risks of the transacted product.

5.1.2.2 COB v fiduciary duty

The previous section examined the differing requirements placed on financial institutions in over-the-counter derivatives transactions by private law and regulation. It was found that financial institutions' obligations in regulation are much more demanding and onerous than in private law. While private law obligates financial institutions as counterparty in an 'arm's length' contract, regulation demands high levels of care and loyalty to consumers, similar to fiduciary duties in private law. The latter concept is considered below, and compared with the COB. This analysis will help to understand the dissonance between requirements of private law and regulation.

Fiduciary duty in private law

Private law defines a fiduciary as 'someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.[1482] The fiduciary relationship is characterized by 'discretion, power to act, and vulnerability'.[1483] Fiduciary duties are crafted in private law to protect the

[1479] See n1353
[1480] [2013] EWHC 3167; see n1370
[1481] See n961
[1482] *Bristol & West Building Society v Mothew* [1998] Ch 1, 18
[1483] Law Commission, *Fiduciary Duties and Regulatory Rules* (Consultation Paper 124, 1992) para 2.4.6

vulnerable principals for whom the fiduciary has power to act.[1484] The core of fiduciary duties is loyalty to the principal.[1485] This duty requires the fiduciary to 'act in good faith'; 'not to profit out of the trust'; 'not to place himself in a position where his duty and his interest may conflict'; and 'not to act for his benefit or the benefit of a third party without consent of the principal'.[1486] There are two types of fiduciaries in private law: the first is recognized as fiduciary by the nature of the relationship, such as trustee and beneficiary; agent and principal; director and company.[1487] The second is open and fact-based, implying that the fiduciary relationship is determined by the facts and circumstances of the relationship.[1488] Even though a financial advisor isn't an already recognized fiduciary like a trustee, agent, or director,[1489] it is 'commonplace for the courts to find that the advisor has placed himself under fiduciary obligations'.[1490] For instance, in *JP Morgan Chase Bank v Springwell*, the court acknowledged the widely ranging duties of an advisor.[1491]

In private law, fiduciary duty arises only when one person agrees to act for, or on behalf of, another person;[1492] the extent of the duties can be modified by the agreement between the fiduciary and the principal.[1493] Therefore, financial institutions attempt to avoid or limit the onerous fiduciary duties through contractual terms of standard forms, which are generally accepted by the courts—except in cases of dishonesty by the

[1484] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Consultation Paper 215, 2014) para 4.12
[1485] John Kay, 'The Kay review of UK equity markets and long-term decision making. Final Report' *(*2012) para 9.6
[1486] *Bristol & West Building Society v Mothew* [1998] Ch 1, 18
[1487] Law Commission, *Fiduciary Duties of Investment Intermediaries* (n1484) para3.14
[1488] Ibid para 3.14-3.16
[1489] Alaistar Hudson, *THE LAW OF FINANCE* (n 413) 5-10
[1490] *Investors Compensation Scheme v West Bromwich Building Society* [1999] Lloyds Rep.PN496, 509; Gerard McMeel and John Virgo (n 1354) para 8.10
[1491] *JP Morgan Chase Bank and Others v Springwell Navigation Corporation* [2008] EWHC 1186 [616]
[1492] *White v Jones* [1995] 2 A.C. 207 at 271; Gerard McMeel and John Virgo (n 1354) para 8.08; James J Edelman, 'When do fiduciary duties arise?' (2010) *Law Quarterly Review* 126, 302, n35
[1493] Alaistar Hudson, *THE LAW OF FINANCE* (n413) 5-04; Simon James (n 423) para 5.4; James J Edelman (n 1492) 315

fiduciary.[1494] As a result, it is rare to see that financial institutions assume a fiduciary obligation or duties as an advisor in transactions of over-the-counter derivatives.[1495]

COB as fiduciary duty

The previous part discussed the concept of fiduciary duties in private law, and the difficulty in seeing those duties arise in over-the-counter derivatives transactions. Next, the COBS in regulation is compared with fiduciary duties in private law. One of the fundamental concepts of COBS came from fiduciary duties in private law. It was announced that the COB of MiFID, from which the COBS was 'intelligently copied',[1496] adopted fiduciary duties for enhancing investor protection.[1497]

Specifically, the COBS demands that a financial institution act in 'the best interests of its client'.[1498] This is the highest level of integrity expected of financial institutions, and is equivalent to 'good faith' of fiduciary duties.[1499] The 'fair communication' rule is also interpreted as a fiduciary duty.[1500] It requires financial institutions, on behalf of consumers, to choose the proper information and way of delivering it in order not to mislead the consumer. The obligation of disclosure of all necessary facts for the consumer's informed decision, which this rule requires, is also seen as a fiduciary duty.[1501]

The COBS demands that financial institutions provide consumers with information on fees charged,[1502] and prohibits them from receiving any fee or non-monetary benefits from third parties related with services to the consumer[1503]. These fee-related rules are similar to 'not to profit out of the trust' and 'not to act for his benefit or the benefit of

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[1494] Alaistar Hudson, *THE LAW OF FINANCE* (n413) location 7005 (kindle edition)

[1495] See Table2 at p 1 8 8 ; Simon James (n 423) para 5.4; Frank Partnoy, 'ISDA, NASD, CFMA, and SDNY: the four horsemen of derivatives regulation?' (2002) 2002.1 *Brookings-Wharton Papers on Financial Services* 213, 221

[1496] Financial Services Authority, 'Reforming COB' (2006) para 2.11

[1497] European Commission, 'BACKGROUND NOTE. Draft Commission Directive implementing the Markets in Financial Instruments Directive 2004/39/EC' (2004) para 7.1

[1498] FCA Handbook, COBS 2.1.1 (1)R

[1499] Alaistar Hudson, 'The synthesis of public and private in finance law' (n1317) n79; Alaistar Hudson, THE LAW OF FINANCE (n 413) para 10.17

[1500] Alaistar Hudson, *THE LAW OF FINANCE* (n 413) para 10.19-10.20

[1501] Gerard McMeel and John Virgo (n 1354) para 8.09

[1502] FCA Handbook, COBS 6.1.9R

[1503] FCA Handbook, COBS 2.3.1R

a third party without consent of the principal' of fiduciary duties.[1504] The suitability rule requires financial institutions first to understand the investment objectives and circumstances of the consumer, and then to provide appropriate advice. This rule is consistent[1505] with the concept of fiduciary duties, in that it places a much higher obligation on financial institutions than *caveat emptor* in private law, which allows institutions to leave it to consumers to evaluate the characteristics and risks of financial products.[1506] In addition, the financial institution should terminate advisory services to the client if their suitability cannot be assessed due to insufficient consumer-related information.[1507] This requires the financial institution to place the interests of consumers above profit, which is similar to fiduciary duties.

While the COBS shares common characteristics with fiduciary duties of private law, there are some critical differences. It was explained above that fiduciary duties in private law arise only when a person undertakes the role of a fiduciary, and that the extent of duties can be contractually modified.[1508] However, the obligations of the COBS take effect without the explicit undertaking of those duties, and cannot be modified or limited by contractual terms. The COBS expressly stipulates that financial institutions should not seek to exclude or rely on any exclusion of obligations under the regulatory system;[1509] the regulator, for instance, announced that the disclaimer of advisory service had no effect on its regulatory actions.[1510] The COBS doesn't accept any relaxation of obligations on financial institutions or reallocation of rights and duties based on what the contract may represent as being 'agreed' between financial institutions and consumers.

Then, why were fiduciary duties, which already existed in private law, written into regulation? Köndgen suggested two answers: first, moving duties of contractual origins

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[1504] Gerard McMeel and John Virgo (n 1354) para 8.17
[1505] Cheryl Goss Weiss, 'Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty' (1997) *J. Corp. L.* 23, 65, 99
[1506] Alaistar Hudson, *THE LAW OF FINANCE* (n 413) para 3.11
[1507] FCA Handbook, COBS 9.2.6R
[1508] See n1492, n1493
[1509] FCA Handbook, COBS 2.1.2R
[1510] Field Fisher Waterhouse, 'A Guide to the New Conduct of Business Sourcebook and new Systems and Controls rules' (2007) 49 <http://www.fieldfisher.com/pdf/NEWCOB-and-SYSC.pdf> accessed 21 July 2016

to public law obligations could 'ensure that rules of conduct become immune against any attempt to contract them out'; second, the legislator was suspicious of consumers' capability to recognize breach of duties by financial institutions and to take private law actions after recognizing the breach, due to burden of proof or financial risk in their litigation.[1511]

5.1.2.3 Different approaches to causation

Section 5.1.1 examined the different duties imposed by private law and regulation of transactions of over-the-counter derivatives. When any breach of duties is found, the next stage for both institutions is to compensate for damages caused. A compensation order, whether by court or the regulator, needs assessment of causation between the breach of duties by financial institutions and the loss of consumers—that is, assessing whether the breach has indeed caused the loss. This section compares the approaches taken by private law and regulation to causation in cases of alleged 'mis-selling' of over-the-counter derivatives.

'Precise' causation of private law

A causation test in private law is the process of 'allocating responsibilities for harm'.[1512] Every case in tort law has a sharp bipolar relationship between litigating parties, where compensation for the claimant means liability for the defendant; tort law is therefore focused on 'corrective justice'.[1513] Hence, private law tries to find the 'precise' answer to the question: '[D]id the financial institution's breach cause the loss of the consumer?'[1514] It endeavours to find what exactly happened 'due to' the breach. In order to reach the 'precise' causation result, 'factual causation' and 'legal causation' tests are applied.[1515]

[1511] Johannes Köndgen, 'Rules of conduct: Further harmonisation' in Guido Ferrarini, *European securities markets: The investment services directive and beyond* (Kluwer Law International 1998) 117

[1512] Per Laleng, 'Causal Responsibility for Uncertainty and Risk in Toxic Torts' (2010) 18 *Tort L. Rev.* 102, 103

[1513] Donal Nolan, 'Causation and the goals of tort law' in Andrew Robertson and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009) n3

[1514] Stephen D Sugarman, 'Precise Justice and Rough Justice: Scientific Causation is Civil Litigation as Compared with Administrative Compensation Plans and Mass Torts Settlements' (2004) 137 < http://works.bepress. com/stephen_sugarman/45> accessed at 1st April 2016

[1515] See n1403

Rubenstein v HSBC Bank demonstrates the court's focus on finding 'precise' causation. The trial court accepted that the financial institution's recommendation of a fund with a limited risk of loss to the consumer (who wanted a product without any risk of principal loss) was unsuitable; it then reasoned that 'but for' the unsuitable advice, the consumer would not have invested in the fund.[1516] To reach this conclusion about factual causation, the trial court thoroughly examined numerous communication records, including telephone conversations and e-mails between the two parties prior to the transaction.[1517] These thoroughly examined records convinced the court of the consumer's reliance on the financial institution and led it to accept 'factual causation'. For the legal causation test, the court heard expert witness about the relationship between the loss of the fund, the fund's characteristics, and the global financial crisis.[1518] Based on the testimony, and its own analysis of the financial market during the crisis, the court denied 'legal causation' since the loss from the fund was due to the financial crisis, which was unforeseeable at the time of giving advice.[1519]

However, the appeals court held a different opinion of causation, stating that the causation test, especially related to regulatory breach, should consider the purpose of regulation.[1520] This is a relatively new perspective in private law, but paradoxically indicates that the courts have adhered to 'precise' causation. Notwithstanding this new suggestion, the appeals court held 'legal causation' in a very 'precise' way: the loss was not remote, because the financial institution recommended a product with 'market risk', which the consumer indeed tried to avoid; the loss was therefore foreseeable.[1521]

[1516] See n1407

[1517] *Adrian Rubenstein v HSBC Bank* [2011] EWHC 2304 [14]-[38]

[1518] Ibid [109]

[1519] See n1412

[1520] *Adrian Rubenstein v HSBC Bank* [2012] EWCA Civ 1184 [45], which said that "It is said that a section 150 claim [the predecessor of section 138D of FSMA 2000, which entitles a statutory right of action for regulatory breach] is subject to identical principles relating to causation, foreseeability and/or remoteness of damage as may apply in contract or tort, and the judge generally made no distinction between any of Mr.Rubenstein's three causes of action for these purposes, or for the purposes of his finding of negligence. However, whereas the underlying principles may be the same, they may operate in different ways, seeing that the purpose of a statutory rule may be more focussed than the general law of tort or contract is likely to be."

[1521] See n1413

The court can be convinced of causality only when both factual and legal causation requirements are satisfied. If the claimant cannot prove the causation factually and legally, the court has to assume that the breach didn't cause the loss. For the court, it isn't permissible to hold that the defendant is liable for losses that she indeed didn't cause.[1522] 'Precise' causation thus doesn't accept causality, unless the claimant proves that she would have acted differently without the breach. In *Green & Rowley v Royal Bank of Scotland Plc*, the consumer entered into a 10-year maturity interest rate swap with the bank to hedge the interest rate risk of his 5-year maturity loan.[1523] The consumer was shocked at the termination cost of almost 30% of his hedged loan when he tried to exit the swap four years after contract entry.[1524] The court said that 'Had they been told that the cost could be substantial..., it is far from clear that they would have stopped there...'.[1525] Unless the court is persuaded that the claimant evidently would have acted differently in the absence of any breach, the causation isn't complete.

'Fair' causation of regulation

FSMA 2000 enables the regulator to use 'power to require restitution'[1526] or establish a 'consumer redress scheme',[1527] with the condition that the loss of consumers is a 'result' of contravention by financial institutions. Therefore, the regulator should also assess causation when it pursues redress for consumers.

While the court pursues 'precise' causation, the regulator can be said to pursue 'fair' causation. This doesn't mean that the regulator's approach to causation is more 'fair' than the court's, but that the regulator seeks to find a 'fair' result from the perspective of its core objectives in investigating causation. In the case of interest rate hedge products, the regulator reasoned that if there were no breach by financial institutions in transacting the products, the 'average' consumer would have selected a simpler IRHP product, such as a plain swap, with a termination cost of less than 7.5% of the nominal amount of

[1522] Stephen D Sugarman (n 1514) 138
[1523] [2012] EWHC 3661
[1524] See n1364
[1525] *Green & Rowley v Royal Bank of Scotland plc* [2012] EWHC 3661 [88]
[1526] FSMA 2000 s384 (1)
[1527] FSMA 2000 s404 (1)

IRHP.[1528] The difference between the causation tests employed by the regulator and the court, respectively, is that the regulator assumed its own prospective result (7.5% termination cost and a simple product)—although circumstances led to the conclusion that the consumer would still have bought an IRHP, even without the bank's breach of regulatory requirements.

The answer to the question: 'how would the consumer have acted if the financial institution had not breached the duties?' is probabilistic—it cannot be answered with certainty.[1529] The regulator pursues a 'fair' answer to this challenging question, within the range of reasonableness.[1530]

5.1.3 Origins of the dissonance

The previous sections considered the dissonance of principles and requirements between private law and regulation in dealing with a 'mis-selling' claim of over-the-counter derivatives. This section investigates reasons for the dissonance between the two institutions. First, the society expects the two institutions to undertake different functions. Second, even with their different functions, the roles of the two institutions are increasingly overlapping, resulting in the collision of their different principles.

5.1.3.1 Different functions of the two institutions

The function of private law

Before discussing the function of private law, it is necessary to consider transactions and contracts in general. Since human beings started producing at surplus, transactions between individuals have existed.[1531] A transaction tends to cultivate mutual economic benefit for participants.[1532] If not, the transaction would not be concluded, because the

[1528] See n990

[1529] Per Laleng (n 1512) 103; see also Financial Ombudsman Service, 'Final Decision on complaint by the W family' (2013) 19 < www.financial-ombudsman.org.uk/.../swaps-bankE-prov-decision.pdf> accessed 3rd April 2016

[1530] Stephen D Sugarman (n 1514) 146

[1531] Adam Smith, *The Wealth of Nations* (1937) 13; Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) location 1332 (Kindle edition)

[1532] Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, 1962) 13; Michael J. Trebilcock, *The Limits of Freedom of Contract (*Havard University Press 1997) 7

party who would suffer a loss would decline to enter into the deal. Assume that a house with £9,500 utility to the current owner has £10,500 utility to someone else. If they agree to transact the house at a price of £10,000, each party gets a £500 utility increase. Social welfare, the aggregate of the utility, is considered to increase by £1,000. As someone in the society then uses the resource (house) with higher utility, the transaction results in more efficient resource allocation. It can therefore be deduced that, without transaction costs, economic resources will be transacted eventually to reach the person in society for whom the value is the largest; it is therefore argued that an overall increase of transactional activity implies improved social welfare.[1533]

In the modern market economy, transactions are usually facilitated through contracts,[1534] which incur transaction costs in its negotiation, formulation, and enforcement. Private law plays a facilitative role for contracting by enabling transactions at minimal cost and by enforcing contracts.[1535] Contract law is considered to facilitate efficient transactions by reducing contracting costs[1536] during negotiations, and to facilitate contract formulation by providing implied terms [1537] and common vocabularies. [1538] Without the latter, contracting parties would spend significant time and energy in defining vocabularies and negotiating terms for all contingencies.[1539]

Contract law is the last resort for enforcing contracts. Enforcement is a critical factor in facilitating contracting, since it convinces parties to enter into contracts by ensuring that obligations will be completed.[1540] The incentive to maintain reputation aids self-policing and enforcement by contracting parties; however, its extent is limited since reputational

[1533] Klaus Mathis, *Efficiency Instead of Justice. Searching for the Philosophical Foundations of the Economic Analysis of Law (*Springer 2009) location 657 (kindle edition)
[1534] Karl N. LLEWELLYN, 'What Price Contract-An Essay in Perspective' in A.I. Ogus and Cento G. Veljanovski, *Readings in the Economics of Law and Regulation* (CLARENDON PRSS 1984) 149-150
[1535] Péter Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach* (n741) 88; Werner Z Hirsch, *Law and economics: an introductory analysis (*Academic press 2015) 130
[1536] Richard A. Posner, *Economic Analysis of Law* (n614) 108; Werner Z Hirsch, *Law and Economics: An Introductory Analysis* (n1536) 130
[1537] Richard A. Posner, *Economic Analysis of Law* (n614) 96; Anthony I. Ogus (n 1534) n 5 (Chapter 2)
[1538] Alan Schwartz, 'Contract theory and theories of contract regulation' (n1317) location 1587 (kindle edition)
[1539] Anthony T. Kronman and Richard A. Posner, *The Economics of Contract Law (*Little, Brown and Co. 1979) 4
[1540] Alan Schwartz, 'Contract theory and theories of contract regulation' (n1317) location 1587 (kindle edition)

capital is finite.[1541] One commentator called this enforcement function of private law 'containing opportunism in non-simultaneous exchanges'.[1542]

Without a compulsory mechanism for contract enforcement and institutions to reduce transaction costs, contracting would be deterred and individual and societal levels of welfare could stagnate. Private law is required to provide an institutional supportive role for facilitating transactions, and to minimize contract-related interventions.[1543] Posner explained that this aspect of private law represented its concern with 'efficiency'.[1544]

For contract law's facilitative role, freedom of contract is a fundamental principle.[1545] This implies 'freedom of choice' with respect to both contracting counterparties and contracting terms.[1546] The principle is based on the philosophical value of 'individual autonomy', as well as the belief that each individual would act in his best interest and always seek to increase his welfare.[1547] In the previous house transaction example, the seller and buyer could maximize their utility by freely agreeing on any terms such as guarantee for fixing defects, apportioning costs and payments, and others. For that reason, private law allows individuals the freedom to contract what they need; it ensures, once agreements are concluded, that they are kept ('*pacta sunt servanda*').[1548]

It can be said that *caveat emptor* is a principle whereby efficiency is enhanced through encouraging the production of information in society. Information is by nature expensive to produce but cheap to deliver. If contracting parties are not allowed to profit from keeping the information that they produce or possess to themselves, they are not

[1541] Benjamin Klein, 'The role of incomplete contracts in self-enforcing relationships' in Eric Brousseau and Jean-Michel Glachant (eds), *The Economics of Contracts* (CAMBRIDGE UNIVERSITY PRESS, 2002) location 825 (Kindle edition)
[1542] Michael J. Trebilcock (n 1532) 16
[1543] John N. Adams and Roger Brownsword, 'The ideologies of Contract Law' (1987) 7 *Legal Stud.* 205, 206-208
[1544] Richard A. Posner, *Economic Analysis of Law* (n614) 24; Richard A Posner, 'A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law' (1981) 9 *Hofstra Law Review* 775, 776; Anthony T. Kronman and Richard A. Posner, *The Economics of Contract Law (*Little, Brown and Co. *1979)* 5
[1545] Péter Cserne (n 1535) 81; John N. Adams and Roger Brownsword (n 1543) 208
[1546] Péter Cserne (n 1535) 81
[1547] Ibid P83
[1548] Klaus Mathis, *Efficiency Instead of Justice. Searching for the Philosophical Foundations of the Economic Analysis of Law (Springer 2009)* Location 1012 (Kindle edition)

motivated to produce information;[1549] this could result in information production below the societal optimal level.[1550]

When reviewing the cases of over-the-counter derivatives, contractual terms were one of the most important considerations for the court.[1551] As an enforcer of contracts, the court should enforce the contractual terms in general. As a consequence, it has to uphold the contractual terms that deny provision of any advice or representation about over-the-counter derivatives, regardless of the pre-contractual negotiations, because the contractual terms are the 'efficient' result of negotiation about risk allocation between independent parties. Under the principle of *caveat emptor*, financial institutions' liability which results from omission to explain facts or features of over-the-counter derivatives isn't upheld.

Here, it is necessary to point out a feature of private law—'generality'—which allows it to encompass most transactions in a vast array of areas.[1552] It permits the court to deal with most transactions in its system.[1553] Generality also provides contracting parties with freedom of contract, because contracts can be adjusted to their specific needs, as opposed to transactions adapted to the legal framework.[1554] While generality empowers private law with expandability, it restrains it from adopting itself to the market failures described below.[1555] The court is bound to sustain the consistency in its adjudications over time and across jurisdictions to maintain doctrinal stability.[1556] Private law cannot make special provisions—which could serve as exceptions of its generally applicable principles—for a certain area only, such as financial products transactions.

[1549] Richard A. Posner, *Economic Analysis of Law* (n614) 111
[1550] Ibid
[1551] See n1329
[1552] Hugh Collins, *REGULATING CONTRACTS* (Oxford, 1999) 46
[1553] Ibid
[1554] Ibid 47
[1555] Ibid
[1556] Andrew Robertson, 'Constraints on Policy-Based Reasoning in Private Law in Robertson' in Andrew, and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009) 261-280

However, there are some prerequisites that qualify transactions as enhancing the welfare of individuals and the entire society. The first is adequate information,[1557] which means that individuals should hold or be able to obtain the necessary information to understand their best choice. If sufficient information about a transaction isn't available, a transaction could decrease an individual's welfare. The second prerequisite is that the contracting party should be rational, which means she acts in her best interest.[1558] Even though the contracting party has sufficient information, a transaction could still be done that decreases welfare if she has bounded rationality in processing the information. [1559] This aspect is discussed in the next section.

The function of regulation

(1) Market failures

The previous section indicated that private law facilitates transactions, which enable individuals to seek their best interest and welfare, thus improving the overall level of societal welfare. However, this proposition is based on the assumption that participants in the market have sufficient information about transactions, and are rational enough to act in their best interests. If these conditions are not fulfilled, freedom of contract could deteriorate welfare rather than guarantee welfare improvement through transactions.[1560] Considering the previous example of a house transaction, if the purchaser is unaware of defects such as ground subsidence (information asymmetry), [1561] or if the house is bought with an unrealistic expectation of price increase in the near future—similar to

[1557] Milton Friedman, *Capitalism and Freedom* (n1532) 13; Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) para 2.5

[1558] Richard A. Posner (n 1536) 1; Cento G. VELJANOVSKI, 'The New Law-and-Economics: A Research Review' in A.I. Ogus and Cento G. Veljanovski, *Readings in the Economics of Law and Regulation* (CLARENDON PRSS 1984) 16

[1559] Richard A. Posner, *Economic Analysis of Law* (n614) 5; CENTO G. VELJANOVSKI (n 1558) 16; Michael J. Trebilcock (n 1532) 118-119

[1560] Michael J. Trebilcock (n 1532) 102-103

[1561] See 4.2.1

some US subprime mortgagors prior to the market meltdown (bounded rationality)[1562]—the transaction would decrease the purchaser's welfare.

As explained in sections 3.2.1 and 3.3.1, informational asymmetry and bounded rationality undermine the preposition that consumers could increase their welfare through financial transactions. However, private law as a facilitator of transactions has structural weaknesses that prevent adequate intervention in market failures.[1563] Posner pointed out that market failures are also the failures of common law.[1564]

First, the principles for facilitation of private law set limits to ameliorate market failures.[1565] For instance, *caveat emptor*—which put the responsibility of realizing the risk of the transaction on the consumer—cannot solve information asymmetry. In terms of bounded rationality, private law implicitly, if not explicitly, has the principle of 'equality and equivalence between individuals'; it therefore cannot provide consumers with 'favourable treatment'.[1566] Second, private law's limitations result from the associated high legal costs.[1567] High litigation expenses, coupled with the uncertainty of adjudication, have deterred consumers from pursuing compensation by private law.[1568] For instance, a litigation cost of £700 thousand to an SME that suffered a loss of £3.5 million from IRHPs would be beyond the financial capability of the majority of SMEs.[1569]

(2) Function of regulation

Regulation is a political response to market failures and the limited capability of private law to address the failures.[1570] To counter information asymmetry between consumers

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[1562] See 4.3.1

[1563] See n1555; Patrick S. Atiyah, *The rise and fall of freedom of contract* (Vol. 61. Oxford: Clarendon Press, 1979) 703

[1564] Richard A. Posner, *Economic Analysis of Law* (n614) 383, 389

[1565] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) Section 2.6

[1566] Ibid

[1567] Ibid; see also Gunther Teubner, 'Juridification' (n838) 394

[1568] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) Section 2.6

[1569] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 62

[1570] Edward L. Glaeser and Andrei Shleifer, 'The rise of the regulatory state' (No. w8650. National Bureau of Economic Research, 2001) 5, 13, 34 available at < http://www.nber.org/papers/w8650> accessed 10th August 2017; in the contrary see Stephen Choi, 'Regulating Investors Not Issuers: A Market-Based Proposal' (2000) *Berkeley Program in Law & Economics*, Working Paper Series 5, where the author argued to regulate the investor rather than financial intermediaries in order to be less parternalistic.

and financial institutions, regulation requires financial institutions to provide consumers with all appropriate information to enable informed investment decisions[1571] and to communicate in a fair, clear, and not misleading manner.[1572] In order to counter consumers' bounded rationality, the suitability rule was adopted. This rule requires financial advisers to know the client, and then recommend only suitable products.[1573] Furthermore, when providing service on an execution basis without any advice, financial institutions should assess whether consumers have appropriate knowledge and experience to understand the risks of complex products.[1574] The suitability and appropriateness rules could protect consumers from their own errors caused by bounded rationality. In the end, regulatory duties—as onerous as fiduciary duties in private law—are imposed on financial institutions.[1575] In summary, the different responses to market failures lead to the dissonance of standards between the two institutions.

(3) Motivation of regulation

The consumer protection function of regulation in the financial services market was discussed above. This section considers the motivation of promulgating regulation. Ostensibly, regulation makers justify the adoption of a new regulatory rule by explaining its necessity to the public interest.[1576] This is aligned with the cost-benefit analysis that the FSMA 2000 requires from the regulator when introducing a new rule.[1577]

However, this is merely the apparent rationale. The debate on the motivation for new regulation has continued for decades. One side has claimed that regulation is made for the general good ('public interest theory'), while the other side has claimed that it emanates from the intention of some groups to abuse government power for their

[1571] FCA Handbook, COBS 2.2.1 (1)R
[1572] FCA Handbook, COBS 4.2.1R
[1573] FCA Handbook, COBS 9.2
[1574] FCA Handbook, COBS 10.2.1R
[1575] See n1497
[1576] Michael E. Levine, and Jennifer L. Forrence, 'Regulatory capture, public interest, and the public agenda: Toward a synthesis' (1990) 6 *Journal of Law, Economics, & Organization* 167, 168; see also Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a Post-Regulatory World' (n1280) 145
[1577] FSMA 2000 s 138I

advantage ('private interest theory'). These two theories are examined below, and implications for the dissonance between private law and regulation are outlined.

Regulation for public interest

Public interest theory explains that regulation is demanded and promulgated for public interest, which cannot be protected by the market system (including private law) from market failures.[1578] It asserts that regulatory intervention is necessary to protect public interest from market failures.[1579] This theory explains that regulation increases social welfare by correcting market failures, as such representing the 'public interest'.[1580] Market failures can range from monopoly, externalities, and information defects, including bounded rationality in processing information.[1581] This theory underlies the rationales offered by legislators or regulators when they propose and justify the introduction of new forms of regulation.[1582]

However, 'public interest' theory has a problem in that it offers no explanation about how 'public interest' is perceived by legislators and moulded into regulation.[1583] Nothing guarantees that legislators will pursue regulation that maximizes social welfare; a voting system through which individual preference is determined cannot ensure that 'public interest' is achieved, since the policy voted for by the majority of voters may cost the remaining minority more compared with the benefit that the majority will gain,[1584] while welfare maximization is possible by individual transactions in the market system.[1585]

Regulation for private interest

[1578] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (n271) 29

[1579] Stephen Breyer, 'ANALYZING REGULATORY FAILURE: MISMATCHES, LESS RESTRICTIVE ALTERNATIVES, AND REFORM' (1978-1979) 92 *Harv. L. Rev.* 547, 553

[1580] Bronwen Morgan and Karen Yeung, *An introduction to law and regulation: text and materials* (n869) 18

[1581] Anthony I. Ogus, 'Whither the economic theory of regulation? What economic theory of regulation?' in Jacint Jordana, and David Levi-Faur (eds), *The politics of regulation: institutions and regulatory reforms for the age of governance* (Edward Elgar Publishing 2004) 32

[1582] See n1576

[1583] Anthony I. Ogus, 'Whither the economic theory of regulation? What economic theory of regulation?' (n 1581) 32

[1584] Ibid 34

[1585] See n1533

Private interest theory assumes that individuals or groups pursue regulation as a way of maximizing their private interest.[1586] The premise of the theory is that regulation is a product by rule-makers (politicians or bureaucrats of regulatory agency) for those who could benefit from the regulation.[1587] Private interest groups, such as industries or occupations with different voting or financial capability to mobilize political power, enter into the 'political market' to benefit from regulation.[1588] The regulator, the supplier of the regulation, demands the political support required to stay in office in exchange for beneficial regulation.[1589]

Implication

The complex and multi-faceted question of whether regulation in the financial services industry is for 'public interest' or 'private interest' is beyond this thesis. However, the theories of regulatory motivations provide an implication. According to the two competing theories, regulation is produced to secure the interests of people— whether they are the general public or private groups—which cannot be done without regulation. This implies that interests which regulation intends to protect cannot be protected by private law, which is why regulation is promulgated. Therefore, these theories show that regulation is destined to have a degree of dissonance with private law.

5.1.3.2 Overlapping roles of the two institutions

Section 5.1.3.1 examined the different functions of private law and regulation, and found that regulation intends to provide interests that cannot be protected by private law. The different functions of the two institutions result in dissonance in their principles and requirements, as seen in section 5.1.2. However, if the territories of the two institutions are completely separate, the dissonance will not be revealed distinctly. The overlapping roles of the two institutions are recent, and result from the expanding roles of financial regulation. These expanding roles can be explained as part of the great tide of 'the rise

[1586] Browen Morgan and Karen Yeung (n 1580) 43
[1587] George J. Stigler, *The citizen and the state: Essays on regulation* (Book Review, 1977) 113-119
[1588] Ibid xi
[1589] Stephen Croley, 'Theories of regulation: Incorporating the administrative approach' [1998] *Columbia Law Review* 1, 35

of the regulatory state', which commenced in the 1980s when Britain started restructuring its economy after the economic crises of the 1960s and 1970s.[1590] In terms of financial regulation, it transformed self-regulation by elite 'clubs' of financial institutions to statutory regulation in 1986 by FSA 1986 enactment.[1591] Under self-regulation, regulatory action was informal and non-legal, including adverse publicity and exclusion from membership of the 'club'.[1592] Thus, self-regulation didn't have many opportunities to intersect with private law. However, as a single statutory authority appeared and financial regulation extended its reach to formal and legal enforcement through FSA 1986 and FSMA 2000, the contradicting aspects between the two institutions have been revealed.

In addition, the powers conferred on the regulator have been expanded. Historically in Britain, private law and regulation had separate roles, namely compensation and deterrence, respectively.[1593] However, in the 'rise of the regulatory state', regulation has evolved from its original aim of remedying a specific market failure to regulating 'social' risk, which could affect 'whole populations'.[1594] This ambitious aim created many large bureaucratic regulatory agencies.[1595] Based on government's initiatives, many researches were conducted and proposals made to increase the efficiency of regulation.[1596] Among them, a 2006 report by Professor Macrory to the government for reforming regulatory sanction included 'restoring harm caused by regulatory non-compliance' as one of its Six Penalties Principles.[1597] With this report adopted, many regulators other than the

[1590] Michael Moran, 'The rise of the regulatory state in Britain' (n890) 20

[1591] Ibid 20; see also p 1 5 0

[1592] Graham F. PIMLOTT (n 458) 148

[1593] Christopher Hodges, 'Developing Approaches to Public and Private Enforcement In Englnad and Wales' in Fabrizo Cafaggi and Hans-Wolfgang Micklitz (eds), *New Frontiers of Consumer Protection* (Intersentia Publishers 2009) 151

[1594] Michael Moran (n 1590) 24

[1595] Ibid 25

[1596] See eg Better Regulation Task Force, *Principles of good regulation* (1998); see Philip Hampton, *Reducing administrative burdens: effective inspection and enforcement* (HM TREASURY, 2005)

[1597] Richard B. Macrory, 'Regulatory Justice: Making Sanctions Effective' (HM Treasury, 2006) 31 available at <http://webarchive.nationalarchives.gov.uk/20121212135622/http:/www.bis.gov.uk/files/file44593.pdf> accessed 26th June 2017

financial regulator were given a right to request compensation orders from the court,[1598] even though the boundary of separated roles in the financial services industry had already begun to be diluted. The latter occurred when the Gower report[1599] proposed enforcement tool that provided the financial regulator[1600] and consumers[1601] with the power to proceed with consumer compensation for loss resulting from regulatory breach by financial institutions; this was adopted by the FSA 1986.

As seen above, the commencement of regulatory compensation was for enforcement of regulation; the FCA still officially states that the main purpose of regulatory compensation is 'credible deterrence', that is the goal of enforcement.[1602] However, in the real world, compensation isn't just a device to reach the goal of regulatory enforcement, but is one of the major separate roles of the financial regulator.[1603]

For example, the financial regulator has demanded that financial institutions compensate their consumers that suffered from their regulatory breach and lowered the sanction level in consideration of compensation.[1604] In the IRHPs scandal, the regulator organized a sales practice review of IRHPs, stating that the core purpose was to pay 'fair and reasonable redress to customers'. In the IRHPs scandal, parliament[1605] and an interest group[1606] mostly demanded fair regulatory compensation from the regulator. Difficult

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[1598] Christopher Hodges, 'Developing Approaches to Public and Private Enforcement In Englnad and Wales' (n 1593) 166

[1599] See Gower, 'Review of Investor Protection: Report' (HM Stationery Office, Cmd., No. 9215, 1984)

[1600] FSA 1986, s 61

[1601] FSA 1986, s 62

[1602] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (FCA, 2013) 19

[1603] Financial Supervisory Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) para 33-34, available at <www.fsa.gov.uk/pubs/other/pls.pdf> accessed 8th October 2017, where it said that "Our experience is that members of the public and Parliamentarians have been of the view that - as a matter of public policy – the breach of the FSA's rules should in all cases entail the consumer receiving 100% redress. However, the FCA's ability to ensure that consumers receive redress is constrained by the general law… If society expects as a matter of public policy that the regulator should be in a position to require greater levels of redress to be paid then the FCA needs to be given a clear mandate and powers to do so in the new legislation. This is a difficult issue that gives rise to real questions as to how far the regulator's powers should extend and we would very much welcome the Committee debating this matter, in particular to achieve further clarity as to the FCA's mandate in this area."

[1604] Financial Services Authority, 'FINAL NOTICE to Savoy Investment Management' (2012) para 2.7. (4); Financial Services Authority, 'FINAL NOTICE to Credit Suisse (UK) Limited' (2011), para 2.5.

[1605] House of Commons Treasury Committee, 'Conduct and competition in SME lending' *(*n976) 36-65

[1606] Bully-Banks was created in December 2011 by business owners each of whom had been mis-sold Interest Rate Hedging Products. <http://www.bully-banks.co.uk/site/> accessed 15 May 2015

accessibility of the private law system is one of causes of this demand.[1607] A simple dichotomy that separates regulation for deterrence and private law for compensation is no longer true.[1608] Regulation, with dissonant standards with private law, becomes involved in 'compensation', which was intended as the role of private law.[1609]

Lastly, another reason for overlapping roles between private law and regulation is the European Union's regulation-oriented policy.[1610] Majone explained that the European Commission, with limited bureaucracy and budget, chose regulation as a device for pursuing its policy goals efficiently.[1611] The Commission promulgates a general regulatory framework and standards, and imposes the duty of enforcing regulation on each member state.[1612] MiFID was also implemented as a regulation, the COBS, in the UK.[1613] Regulatory rules for consumer protection of MiFID and the COBS, such as the suitability rule, concern the contractual relationship between financial institutions and consumers, and allocate rights and obligations in the relationship—all of which traditionally used to be the role of private law.[1614] Regulation resulted in regulating

[1607] House of Commons Treasury Committee (n 1605) 62; see also THIRUVALLORE T. ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State', in Kit Barker, Karen Fairweather and Ross Grantham, *Private Law in the 21st Century* (Bloomsbury, 2017) 13-14

[1608] Fabrizio Cafaggi, *A coordinated approach to regulation and civil liability in European Law: Rethinking institutional complementarities* (European University Institute 2005) 194-195; Susan Rose-Ackerman, *Rethinking the progressive agenda* (n1318) 118

[1609] THIRUVALLORE T. ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State' (n1607) n15

[1610] Hans-W. Micklitz, 'Administrative Enforcement of European Private Law' (n1318) 563, where the author explained that private law rules in EU directives are 'regulatory private law'; see also Hans-W. Micklitz, Yane Svetiev and Guido Comparato, 'European Regulatory Private Law – The Paradigms Tested' 5, where the authors used a similar term of 'regulated autonomy', available at <http://ssrn.com/abstract=2423306> accessed 2nd August 2017

[1611] Giandomenico Majone and Pio Baake (n818) 66

[1612] Ibid

[1613] Guido Ferrarini, 'Contract standards and the Markets in Financial Instruments Directive (MiFID): An assessment of the Lamfalussy regulatory architecture' (2005) 1.1 *European Review of Contract Law* 19, 20-21

[1614] Stefan Grundmann and Jörg Hollering, 'EC Financial Services and Contract Law–Developments 2005–2007' (2008) 4.1 *European Review of Contract Law* 45, 62

contractual relationships, which is the major role of private law.[1615] Mülbert has described this phenomenon as a 'partial eclipse of contract law'.[1616]

However, regulation doesn't intend to override the principles of private law.[1617] FSMA 2000 expresses that contravention of regulatory rules doesn't make a contract void or unenforceable.[1618] Regulation, while pursuing its objective of consumer protection, attempts to confine its impact to only what is necessary to achieve its objectives, so as not to intrude into the territory of private law. This stance was well illustrated by the opinion presented by HM Treasury and the FSA on the question 'what is your opinion on introducing a principle of civil liability applicable to investment firms' in the process of MiFID review.[1619] The stance was that the government attempts to enhance consumer protection in market failures by regulation, but intends to refrain from expanding too much into the sphere of private law. Confining regulation to the public sphere is one of the reasons for continuation of the dissonance of requirements between private law and regulation.

5.2 Private enforcement in South Korea

[1615] THIRUVALLORE T. ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State' (n1607) n4

[1616] Peter O. Mülbert, 'The Eclipse of Contract Law in the Investment Firm-Client Relationship: The Impact of the MiFID on the Law of Contract from a German Perspective', in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press 2007) 320

[1617] Olha O. Cherednychenko, 'European securities regulation, private law and the investment firm-client relationship' (2009) 17.5 *European Review of Private Law* 925, 930

[1618] FSMA 2000 s138E (2)

[1619] HM TREASURY and FSA, 'UK response to the Commission Services consultation on the Review of the Markets in Financial Instruments Directive (MiFID)' (2011) 79, available at <https://circabc.europa.eu/d/d/workspace/SpacesStore/74845825-a382-40d1-93e8-7ff334ff6a12/Joint%20Response%20-%20UK%20Treasury%20%26%20FSA.pdf> accessed 21 July 2016, which said that "In introducing a principle of civil liability we think that it is necessary to be careful about disturbing existing legal systems. We think that it would be better to require Member States to impose liability on investment firms for which they are the Home Member State than to attempt to impose a harmonised standard of liability. It would be difficult to achieve agreement on the latter and the end result could work awkwardly in some jurisdictions. We also believe that careful consideration needs to be given to scope of a principle of civil liability. In the UK the principle has more or less been restricted to investment firms' dealings with natural persons. This has reflected an effort to strike a balance between investor protection and the legal risk of providing investment services."

5.2.1 Private law about 'mis-selling' over-the-counter derivatives

In South Korea, COB, such as the suitability rule and 'duty to explain', became statutory regulation with the enactment of the FISCM Act in 2009. Prior to this, there was no regulatory legislation on alleged 'mis-selling' of financial products to bind the court, and disputes were resolved by the court's adjudication based on the country's general private law. This section examines the South Korean court's approach to disputes of 'mis-selling' of over-the-counter derivatives before and after the FISCM Act.

5.2.1.1 Private law before FISCM Act enactment

South Korean case law on 'mis-selling' disputes is founded on 'the principle of self-responsibility' of investors. This principle implies that 'the investor, based on information presented to him, is responsible for determining the riskiness of the transaction in making the investment and for bearing the risk that follows'.[1620] It doesn't consider the value of the financial investment product as guaranteed by law, and regards the decision about value as dependent on the investor's judgement.[1621] According to the principle of self-responsibility, a financial investment product is a choice between various mixes of risk and return. It comprises a trade-off relationship, and an investor who chooses risk for high return should take responsibility for the risk.

However, in the 1990s, disputes around investment recommendations by securities companies increased;[1622] consequently, the court established 'the duty to protect customers'. This duty of the financial institution was first recognised in case *93Da26205* in 1993. Here, the Supreme Court defined the contravention of the duty to protect customers.[1623]

[1620] *Seoul Jipan 99 Gahap 5212*

[1621] Ahn Soohyun, '금융소비자보호와 자본시장법의 과제 [Task of Financial Consumer Protection and FISCM Act]' (2008) 22.4 *Study of Company Law,* 73

[1622] See section 3.4.3.1

[1623] *Supreme Court 93 Da 26205,* where it stated that "When all factors are comprehensively considered, including the procedures and methods involved in the transaction, the customer's investment circumstances, the transaction risk, extent of explanation about the risk, etc, the recommendation activity can be seen as abandoning the 'duty to protect customers, which hinders the general investor, who lacks experience, from

In this adjudication, the concept of 'duties to protect customers' included two sub-duties: first, the duty to avoid hindering the investor's accurate understanding of the investment ('duty to explain principle') and, second, the duty to avoid actively recommending a transaction that involves excessive risk relative to the investor's investment circumstances ('suitability principle').[1624] Note that the duties of the case are similar to the 'duty to explain'[1625] and suitability rule[1626] of the FISCM Act, which would be enacted much later.

In *Seoul Jipan 97GAHAP21049*, the court recognised the financial institution's duty to avoid hindering the investor's accurate understanding ('duty to explain principle') in selling a futures-embedded beneficiary certificate, and ordered compensation for losses.[1627]

The first decision involving the 'suitability principle' was *Seoul Jipan 99GAHAP 5212*. In 1996, a financial institution recommended to retail consumers sovereign bonds issued by Russia and Eastern European countries; in 1998, when Russia declared its moratorium, the purchasers incurred large losses. Here, the court didn't consider the government bonds as unsuitable financial products, since there was no previous history of default and futures contracts had been made to avoid foreign exchange risk.[1628]

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accurately understanding the risk that is inevitable with such a transaction or which actively recommends a transaction that involves risk that is excessive considering the investor's investment circumstances."

[1624] Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender] (*n924) 163-189

[1625] See 4.2.3

[1626] See 4.3.3

[1627] *Seoul Jipan 97 Gahap 21049,* where it stated that "there is the duty to protect by enabling the plaintiff to sufficiently consider the loss that may be incurred as a result of his investment by adequately explaining the characteristics of the beneficiary certificate and the possibility of gain from the transaction as well as the possibility of loss..."

[1628] Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender] (*n924) 185; the court stated that "In comprehensively considering the transaction process and method, the plaintiff's investment circumstances, the riskiness of the transaction and the extent of explanation by the employees of the financial institution, it is difficult to see the defendant's recommendation actions as breaches of the suitability principle where a transaction with risk that is excessive, considering the investment circumstances of the plaintiff, was actively recommended."

The KIKO[1629] scandal, which occurred prior to enactment of the FISCM Act, demonstrated application of the duty to protect customers in a specific circumstance.

The court's stance became evident through its decisions on KIKO-related disputes, stating that first, depending on the consumer's experience and knowledge, the extent of the 'principle of self-responsibility' and the financial institution's duty to protect customers changes. In *Supreme Court 2013 Da 26746*, medium-sized Monami Co. signed a KIKO contract for six times the expected amount of US Dollars to be received, and incurred extensive losses. However, the court decided that, as Monami Co. had a professional foreign exchange risk management team that actively presented the contract terms of KIKO, the consumer had intentionally selected KIKO's speculative transactions. The court therefore decided that the financial institution didn't breach the 'suitability principle'.

In *Supreme Court 2012 Da 1153*, Seshin Co. also had KIKO contracts exceeding the expected amount of incoming foreign currency. However, the court recognised the financial institution's breach of the 'suitability principle'. Seshin Co. had already held KIKO contracts for the expected amount of incoming foreign currency of $12 million, but the Shinhan Bank sales representative recommended additional KIKO contracts. The Supreme Court saw this as a recommendation for speculative transactions to a consumer who had no specialised knowledge and no intention of speculating, and therefore as a breach of the suitability principle and against the duty to protect customers.

Second, the court took the stance that in circumstances where it is difficult to apply the consumer's 'principle of self-responsibility' due to informational asymmetry—for example, in transactions involving complex financial products such as KIKO—a higher level of duty to protect customers is required. This includes understanding the consumer's assets or business status when recommending the over-the-counter derivative product. In *Supreme Court 2012 Da 13637*, the Supreme Court contemplated the fact that no consideration was made of Samco Co.'s expected inflow of foreign currency based on

[1629] See p 1

historic export records, and that merely the total sales volume was considered in consequently selling over-hedged KIKO. It therefore decided that the financial institution had breached the suitability principle. In contrast, the Supreme Court decided in *Supreme Court 2011 Da 53683* that the financial institution that sold KIKO to Susan Heavy Industrial Co. within the annual foreign currency inflow amount complied with the suitability principle.

Third, the court defined the scope of the 'duty to explain principle' as key information needed to accurately assess the financial product's structure and risk. In the KIKO disputes, key information was judged to include the KIKO structure and basic product information, as well as details about the earning and loss that the consumer could incur. However, information such as the financial engineering structure, comparative information with other products, and negative value[1630] of over-the-counter derivatives was not considered important in assessing risk, and therefore not judged as within scope of the 'duty to explain principle'.[1631]

5.2.1.2 Private enforcement after FISCM Act enactment

The FISCM Act turned the suitability and duty to explain principles of private law into statutory obligation, but the newly made regulatory obligations didn't conflict with 'the duty to protect customer' created under case law. Some commentators asserted that the COB of the FISCM Act represents the enactment of the customer protection duty of case law into legislation.[1632]

The FISCM Act added the clear stipulation that financial institutions have the responsibility to compensate for detriment resulting from regulatory breach to private law's customer protection duty, thus giving consumers 'right of action' as well as 'right of

[1630] See p 2 3 9 for the general meaning and comparing the adjudication of the UK court.
[1631] *Daebup* 2013,9.26, *2012 Da 1153*
[1632] Kim Gunsik and Jung Sunsup, *Financial Investment Service and Capital Markets Act* (Dusungsa, 2013) 777

compensation'.[1633] In other words, 'right of compensation' was legislated clearly to bind the court's decision in private law.

Second, the FISCM Act stipulated the proxy rules for the regulated and regulator to be able to implement the suitability rule and 'duty to explain'. These proxy rules defined the procedures to be followed for compliance with the suitability rule and duty to explain.[1634]

The court was a better enforcer of the spirit of the COB of the FISCM Act than the regulator. It didn't rely on the proxy rules, but instead focused on the substance of the COB in adjudicating on disputes of 'mis-selling' of financial products. In contrast, the regulator's enforced the vague and purposive requirements of the suitability and duty to explain rules, focusing on forms rather than substance.[1635]

Supreme Court 2013 Da 217498 demonstrates the court's substance-focused enforcement approach.[1636] Here, a sales representative of Hankook Investment Co. recommended to a consumer a discretionary investment contract, which invested in index warrants which pursued a neutral market position and a profit of bond yield + α. The consumer's investment propensity was that of an 'aggressive investor',[1637] and the index warrants were suitable according to the standard WRIR (Working Rules on Investment Recommendation).[1638] The court judged that the consumer changed his propensity on the form in order to invest in a risky and inappropriate product; but it didn't recognise the validity of the changed propensity of the form. Instead, based on the fact that the consumer was of old age and that past investment history indicated a tendency to pursue stable profit rather than high risk for high returns, the court adjudicated that the discretionary investment contract for index warrants was unsuitable.

As the suitability rule and duty to explain are vague and purposive requirements, application of these duties to the idiosyncratic circumstances of reality requires

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[1633] See p 1 1 1

[1634] See p 1 1 3

[1635] See section 5.2.2 and 5.2.3

[1636] *Supreme Court 2013 Da 217498*

[1637] See p 1 2 8

[1638] Ibid

discretionary decisions to determine the extent of the duties. The court has shown its capability to make discretionary decisions about the extent of the vague requirements for each case put before it. 'mis-selling' of the Daehan Marine Service corporate bond serves as a good example. Hyundai Securities Co. was the underwriter of the twenty million US Dollar corporate bonds issued by Daehan Marine Service, and sold them to ordinary investors. Hyundai Securities Co. informed the purchasers that the bond's credit rating was BBB+ and that loss of the investment principal was possible. When the loss was realised with the bankruptcy of Daehan Marine Service, the investors accused Hyundai Securities Co. of breaching the 'duty to explain' of the FISCM Act, as it failed to explain the business environment or the financial situation of Daehan Marine Service and to specifically alert the investors to consider the investment risk as specified in the explanation materials.

In this case, the Seoul Central Distrcit Court judged that there was a breach of the duty to explain based on the decision that '[D]espite the uncertainty about Daehan Marine Service's ability to repay the principal and interest of the bond…the explanation material had wordings that stated that repayment of principal and interest should be possible.'[1639] However, the Supreme Court's decision was that 'if the financial institution provided explanation about the bond's credit rating… the financial institution can be deemed to have executed its responsibility to explain about the issuer's credit risk', and judged that Hyundai Securities Co. complied with the 'duty to explain' of the FISCM Act.[1640] In other words, the Court specified the scope of 'duty to explain' by judging that, when explanation is provided to the investors about the credit rating issued by a recognised credit agency then failing to additionally guide the investor to consider the investment risk elements isn't a breach of the duty to explain.

5.2.2 Characteristics of private enforcement in South Korea

The cases analysed above demonstrates various characteristics of South Korea's private enforcement. First, there is harmonization between the case law and statutory regulation.

[1639] *Seoul Central District 2011 Gahap 122683*
[1640] *Supreme Court 2015 Da 216123*

Even before the FISCM Act was enacted, the court developed the principle of financial institutions' duty to protect customers. The suitability rule and duty to explain, legislated through the FISCM Act, were almost identical to the court's duty to protect customers. The FISCM Act specified a vague duty to protect customers, and made it clear that there is liability for detriments incurred due to breach of the COB promulgated in the FISCM Act.[1641] In particular, considering the loss incurred from breach of the 'duty to explain', the total investment-related loss is presumed as the detriment. The burden of the consumer's proof of causation is therefore eliminated, and there is clarity that the financial institution's liability equals the entire loss of the investment.[1642] In summary, the COB could be considered a more specific and clearer version of the duty to protect customers developed by case law.

Second, the court and the regulator have separate roles in enforcing the COB in South Korea, while they overlap in the UK.[1643] South Korean legislation doesn't provide its regulator any redress authority for handling detriments from regulatory breach. The regulator can only take disciplinary action against financial institutions for regulatory breach. In South Korea, the regulator operates an alternative dispute resolution system—the Financial Disputes Mediation Committee [1644] —but the mediation isn't very effective. [1645] The committee's mediation proposal is a mere recommendation, and stakeholders in the dispute, including the financial institutions, could refuse to accept the proposal. If any one of the stakeholders refuses the proposal, the mediation doesn't take effect.[1646] Further, the mediation ceases if any one of the stakeholders takes the case to court.[1647] When the mediation proposal is expected not to be in their favour, financial institutions take the case to court to terminate the process.[1648] In summary, there is clear

[1641] FISCM Act article 64 (1)

[1642] See p 1 1 1

[1643] See section 5.1.3.2

[1644] Act of The Establishment, ETC. of Financial Services Commission Article 51

[1645] Ko Dongwon, 'Legislative Proposals for Improving the Financial Dispute Conciliation System in Korea' [2013] 5.1 *Legislation and Policy* 63

[1646] Act of The Establishment, ETC. of Financial Services Commission Article 53 (5)

[1647] Act of The Establishment, ETC. of Financial Services Commission Article 53 (2)

[1648] Kwon Tacki, *금융소비자보호원 설립의 필요성 [The Necessity of Financial Consumer Protection Beureau]* (Korea National Assembly, 2009) 91

separation of roles in South Korea: corrective justice by the regulator and restorative justice by the court.

In contrast, the UK is an international leader in pursuing restorative justice through its public regulatory enforcement.[1649] FSA, the UK precedent financial regulator, announced that it would prioritize disgorgement (restitution), discipline (financial penalty), and deterrence—in that order—in its enforcement.[1650]

5.3 Evaluation of effectiveness of private enforcement

Chapter I showed that the public enforcement and private enforcement generally have complementarity.[1651] This section examines the interplay between the COB and private law in the UK and South Korea.

5.3.1 The UK

The UK's COB regime is characterised by the overlapping roles of deterrence and compensation between private law and public regulation. This characteristic implies that interplay between the two institutions can be harmonized but counter-effective at the same time. Another characteristic is the differences between the legal requirements of private law and public regulation. For example, the duties required by the two legal systems for transactions of financial instruments differ, as does the extent of proof of causation that is required for compensation. The following sections examine how the two institutions in the UK interact in standard setting, monitoring, and enforcement.

5.3.1.1 Standard setting

[1649] Richard B. Macrory, 'Regulatory Justice: Making Sanctions Effective' (n1597) Principle 2 and 5; see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 6650-6998 (kindle edition)

[1650] Financial Services Authority, 'Consultation Paper: Enforcement Financial Penalties' (CP09/19, 2009), available at <http://www.fsa.gov.uk/pubs/cp/cp09_19.pdf> accessed 26th June 2017; see also Christopher Hodge, 'Public and Private Enforcement: The Practical Implications for Policy Architecture' in Roger Brownsword, Hans-W Micklitz and Leone Niglia, *Foundations of European Private Law (*Bloomsbury Publishing, 2011) location 13220-13250 (kindle edition)

[1651] Section 1.3.2.3

Both private law and regulation have the function of standard setting, and apply their own standards in cases of 'mis-selling' of financial products—including over-the-counter derivatives. However, as outlined in section 5.1.2, the standards of the two institutions are divergent and sometimes conflicting. The dissonance of, and difference in, standards is mainly due to their differing functions: private law's function of facilitating transactions in the market and regulation's function of remediating market failures.[1652] Even though each institution's standards have their own rationale, the divergence of standards causes substantial legal uncertainty; a transaction of over-the-counter derivatives can be seen as a 'mis-selling' under regulation, but isn't seen as a wrongdoing requiring compensation under private law.[1653]

Besides the uncertainty, the dissonance can prevent the market from creating a moral norm in the area of financial products transactions, by blurring 'the right' and 'the wrong'. Kagan argued that regulatory norms were morally ambiguous compared with other legal norms in, for example, criminology, and that a clear standard is important for creating moral norms in the regulatory space.[1654] Moral norms are internalized in market participants' decision process, thus representing a very efficient system for maintaining a desirable order with low costs.[1655] More importantly, any social institution cannot successfully achieve its goals 'without being internalized by the citizens and without robust backing of social norms.'[1656] The dissonance not only hinders the creation of a norm, but could also create an opportunistic attitude in market participants: financial

[1652] See 5.1.3.1
[1653] See 5.1.2
[1654] See Rober A. Kagan, 'On Regulatory Inspectorates and Police' in Keith Hawkins and John M. Thomas, *Enforcing Regulation (*Springer, 1983) 53
[1655] Jean-Philippe Platteau, 'Behind the market stage where real societies exist-part II: The role of moral norms' (n1215) 802; Avner Greif, 'Contracting, enforcement and efficiency: Economics beyond the law' *in Annual World Bank Conference on Development Economics 1996* (The World Bank 1997) 242; Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 6116 (kindle edition)
[1656] Anastassios D. Karayiannis and Aristides N. Hatzis, 'Morality, social norms and the rule of law as transaction cost-saving devices: the case of ancient Athens' (2012) 33.3 *European Journal of Law and Economics* 621, 622; see also Jesper B. Sørensen, 'The strength of corporate culture and the reliability of firm performance' (2002) 47.1 *Administrative science quarterly* 70, 72; see also William Blair, 'Reconceptualizing the Role of Standards in Supporting Financial Regulation' in *Reconceptualising Global Finance and its Regulation* (Cambridge University Press) 446-467

institutions focusing on technical approaches to avoid legal or regulatory liability, rather than making cultural or procedural improvements in its sales practice for better consumer protection;[1657] and consumers seeking more protective regulation when their financial products disappoint, rather than taking responsibility for their investment decisions[1658].

It can be argued that the dissonance of standards between the two institutions is one of the main causes of the failure to develop the right culture[1659] in the UK's financial services industry. UK policy makers and regulators have implicated 'wrong culture' as the fundamental cause of continuous 'mis-selling' scandals, and have made various attempts to remedy the situation, ranging from the TCF initiative to culture review and SMCR.[1660] A reason for the lack of success of these efforts is that the principles of private law that are in conflict with the regulatory order still represent important social norms. In particular, if the 'wrong culture' is interpreted as the attitude of pursuing excessive self-interest, there can only be but moral ambiguity in capitalism, since its foundation is individuals pursing self-interest.[1661] It is difficult for public regulation, which is incompatible with private law, to have ethical authority and instil the 'right culture'—indicating that constituents of the financial services industry have internalised the motivation to follow the norms pursued by regulation.

5.3.1.2 Monitoring

Regulatory monitoring

[1657] Alaistar Hudson, *The law of finance* (n 413) para 5.37-41

[1658] Yane SVETIEV and Annetje OTTOW. 'Financial supervision in the interstices between public and private law' (2014) 10.4 *European review of contract law* 496, 511

[1659] See p 1 8 4

[1660] See V.1.3

[1661] See Milton Friedman, *Capitalism and Freedom* (n1532) 133, where he argued that 'there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.'; see also David Campbell and Joan Loughrey, 'The Regulation of Self-interest in Financial Markets' in Justin O'Brien and George Gilligan, *Integrity, Risk and Accountability in Capital Markets: Regulating Culture (*Bloomsbury Publishing, 2015) location 3272 (kindle edition); see also Fiona Haines, 'Facing the compliance challenge: Hercules, Houdini or the Charge of the Light Bridge' (n1267) 296

Monitoring by regulation takes place both before and after the occurrence of breach, which is an advantage of regulation over private law.[1662] The FCA, the current financial regulator, engages in both pre-emptive and reactive monitoring and intervention. The 'three pillars' of supervision—announced by the FCA to achieve its consumer protection objectives—demonstrates its approach to monitoring.[1663] The three pillars — 'firm systematic framework', 'event supervision', and 'issues and product supervision' — involve both pre-emptive and reactive monitoring and intervention. This section examines the three pillars with a focus on monitoring activities.[1664]

For pre-emptive monitoring, the FCA periodically examines financial institutions' culture, governance, business processes, and internal controls to ensure that business is conducted in the interest of consumers ('firm systematic framework'); it conducts thematic reviews to analyse emerging risks in multiple firms or sectors ('issues and product supervision').[1665] The 'firm systematic framework' involves a general assessment of financial institutions, covering areas such as business strategy, growth rate, and profitability, and could lead to in-depth examination if a risk is identified.[1666] This framework is applied only to a small number of financial institutions selected for the importance of their market presence.[1667] If the risk identified through the framework or other intelligence sources could potentially be widespread, the 'issues and product supervision' can commence thematic reviews over multiple firms or sectors.[1668]

Periodic on-site review[1669] is another example of 'firm systematic framework', and 'issues and product supervision' could for instance include reviews[1670] of a specific product or mystery shopping.[1671] The objectives of 'firm systematic framework' and 'issues and

[1662] See 5.3.2
[1663] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (n1602) 18-19
[1664] Ibid
[1665] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (2015) 11-12 and 15-22
[1666] Ibid 15-19
[1667] Ibid 9
[1668] Ibid 21-22
[1669] Ibid 18
[1670] Ibid 22
[1671] Ibid

product supervision' are pre-emptive monitoring that is focused on identifying risk factors before consumers suffer detriments.

The FCA significantly emphasizes pre-emptive monitoring; the regulator can detect potential risk in advance and prevent consumer detriments.[1672] However, pre-emptive monitoring cannot capture all potential risks of consumer detriment,[1673] due to the numerous financial institutions (about 26,000) that the FCA has to monitor;[1674] further, it doesn't have an omniscient ability to anticipate all possible future detriment.[1675] Thus, the FCA also employs 'event supervision' as an ex-post or reactive monitoring method.[1676] It represents a regulatory action, following occurrence of consumer detriment that is focused on 'the most important issues' for the regulator's objectives of consumer protection.[1677] The regulator's approach to event supervision is proportionate to the seriousness and significance of the issue.[1678] The monitoring system of the FCA is designed not to address complaints of individual consumers. Instead, it guides consumers to register complaints only to the sellers or the Financial Ombudsman Service.[1679] For instance, in the case of interest rate hedge products that had significant social impact, many complaints reached the regulator through consumers' MPs and the media.[1680]

In summary, the FCA's monitoring strategy aims for the earliest possible identification of consumer detriment risks while using its regulatory resources efficiently. The balanced deployment of ex-ante and ex-post monitoring can be understood as an attempt to improve monitoring efficiency, because the approach of prior identification of all risks is

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[1672] Ibid 17, 20

[1673] Maria J. Glover (n 170) 1148; see eg Yane SVETIEV and Annetje OTTOW (n 1658) 508; European Securities and Markets Authority, *MiFID-Conduct of Business, fair, clear and not misleading information (*ESMA/2014/1485, 2014) para 23

[1674] Financial Conduct Authority, 'The FCA's approach to advancing its objectives' (n1602) 6

[1675] Maria J. Glover (n 170) 1148

[1676] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (n1665) 15

[1677] Ibid 20

[1678] Ibid

[1679] See 'How to complain' section in FCA homepage <http://www.fca.org.uk/consumers/complaints-and-compensation/how-to-complain> accessed 8th October 2017

[1680] Financial Supervisory Authority, 'FSA update: Interest rate hedging products-Information about our work and findings' (2012) 2

very costly. Its strategic focus of the monitoring 'big issues' is also aimed at efficiency.[1681] As described in section 5.1.2, monitoring by a regulator is selective.[1682] The FCA explains that the importance of the issue depends on the 'nature and size' of the problem.[1683] Prioritization of issues based on their nature and size is aligned with one of its regulatory principles—'use its resources in the most efficient and economic way'—as stipulated by FSMA 2000.[1684]

Another reason could be that the FCA is answerable to parliament, and naturally concentrates on politically sensitive issues. The history of regulatory sanctions against the 'mis-selling' of over-the-counter derivatives, which had large-scaled consumer detriments (or risks) involving up to hundreds of thousands of consumers, illustrates this tendency of the regulator.[1685] However, this efficient allocation of monitoring resources inevitably creates blind spots for regulatory monitoring. Consumer detriments where the 'nature and size' isn't deemed significant by the regulator's criteria can continuously be outside of the regulator's monitoring radar.

However, suffering but undetected consumers are not necessarily outside of the monitoring system's notice. Eligible consumers can complain to the FOS for compensation;[1686] their claims will be determined based on 'fairness and reasonableness', and the financial institution will be ordered to compensate them.[1687] Regulatory rules are one of the most important criteria for the FOS's determination of 'fairness and reasonableness'.[1688] Therefore, it can be said that the FOS functions as part of the regulatory monitoring system, providing robust and easily accessible monitoring for

[1681] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (n1665) 7 and 20; Financial Conduct Authority, 'FCA Our strategy' (2014) 6

[1682] See p 2 9

[1683] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (n1665) 20

[1684] FSMA 2000 s 3B (1) (a)

[1685] See p 1 7 2

[1686] FSMA 2000, s 225 and Sch 17, Para 2

[1687] FSMA 2000, s 226 (3) and s 228 (2)

[1688] Alistair Alcock, *The Financial Services and Markets Act 2000: A Guide to The New Law* (JORDANS 2000) 135

detecting consumer detriments; it is free of charge with a much quicker and less formal adjudication process.[1689]

The FOS's monitoring limits are its narrow eligibility for complainants; natural persons or micro enterprises[1690] with less than 10 employees and less than €2 million of turnover or balance sheet are eligible.[1691] Another limit is that awarded compensation cannot exceed £150,000.[1692] Due to these limitations, the FOS cannot address all the consumer detriments not detected by the regulator.

The FCA acknowledged that businesses ineligible to complain to the FOS may represent a large portion of the SME sector;[1693] 61% of SME bank loans outstanding at the end of 2014 were to businesses outside the remit of the FOS, with turnovers of over £2 million.[1694] In particular, the IRHPs scandal brought to light the limited remit of the FOS. The Parliamentary Commission on Banking Standards (PCBS) pointed out that many SMEs who suffered loss from IRHPs were found to be outside the remit of the FOS;[1695] the PCBS referred to a report[1696] stating that, one third of the SMEs with a turnover that exceeded the remit of the FOS didn't have dedicated financial management staff. The PCBS acknowledged that many SMEs excluded from the remit of the FOS didn't have the capability to proceed with civil actions against banks, even with valid cases, and thus recommended the FCA to consider expanding the ombudsman's remit.[1697]

However, extending the remit cannot entirely illuminate the blind spots of regulatory monitoring. It isn't possible to completely remove the limit of the remit of the FOS, because it would disturb the entire legal system of the financial services sector. In

[1689] FSMA 2000, s 225 and Sch 17, Para 2; House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 63

[1690] Financial Conduct Authority, FCA Handbook, Glossary, micro-enterprise <https://www.handbook.fca.org.uk/handbook/glossary/G2623.html> accessed 8th October 2017

[1691] FCA Handbook, DISP 2.7.1R, 2.7.3R

[1692] FCA Handbook, DISP 3.7.4R

[1693] Financial Conduct Authority, 'Our approach to SMEs as users of financial service' (2015) 8 and 30

[1694] British Bankers Association, 'Bank Support for SMEs – 4th Quarter 2014' (2015) <https://www.bba.org.uk/news/statistics/smestatistics/bank-support-for-smes-4th-quarter-2014/> accessed on 1 November 2015

[1695] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 65

[1696] Ibid n316

[1697] Ibid 65

addition, as the PCBS acknowledged, too wide a remit of the FOS would be burdensome.[1698] Even with an extended remit, there would inevitably be a group of individuals and SMEs that remained outside of the regulator's monitoring radar.

In summary, the UK's current system of regulatory monitoring of financial product transactions has loopholes in that some consumer detriments may go undetected—by the regulator due to its selective monitoring, and by the FOS due to its limited eligibility. If regulatory enforcement is episodic, it might take very long for regulation to reach 'social norms' status.[1699]

Monitoring by private law

Does monitoring by private law complement the regulatory 'failures' in monitoring? Considering the cases of 'mis-selling' of over-the-counter derivatives, this isn't the case. In principle, any consumer who failed to receive compensation from regulation can approach the court; monitoring of private law takes place through litigation raised by consumers. However, they will only do so when they expect to succeed in the litigation. Section 5.1 indicated that the prospect of successful litigation by those affected isn't attractive, considering the fact that only one consumer out of 13 secured a redress order from the court.[1700]

The court confirmed that corporate consumers other than natural persons, even micro enterprises, are not entitled to a statutory 'right of action' for breach of regulatory duty;[1701] no consumers have succeeded in attaining compensation through litigation of 'mis-selling' of over-the-counter derivatives based on common law principles.[1702] Even private persons with a statutory 'right of action' under section 138D failed to receive

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[1698] Ibid

[1699] Paul Tucker, 'Banking Culture: Regulatory Arbitrage, Values, and Honest Conduct' in Patrcik S. Kenadjian and Andreas Dombret, *Getting the culture* (n1220) Location 1966

[1700] See Table 1 at p 1 6 3 ; see also Per-Olof Bjuggren, Dan Magnusson and Carl Martin Roos, 'Should a Regulatory Body Control Insurance Policies Ex Ante or Is Ex Post Control More Effective?' (1994) 19 *The Geneva Papers on Risk and Insurance*, 37, 42; see also Robert D. Cooter and Daniel L. Rubinfeld, 'Economic analysis of legal disputes and their resolution' [1989] 27.3 *Journal of Economic Literature* 1067

[1701] See n1389

[1702] See Table 1 at p 1 6 3

compensation in litigation due to the failure to establish a causal relationship between the breach of regulatory rules and their loss.[1703] As a result, consumers' expectation of judiciary redress for their claims would be low, whether based on statutory regulation or on common law. Under such legal circumstances, it is difficult to anticipate that consumers will bring their claims to court, even in valid cases.[1704] This means that the monitoring of private law doesn't play a complementary role in addressing the blind spots on the UK's regulatory radar.

5.3.1.3 Enforcement and intervention

Regulatory Enforcement and intervention

The UK's financial regulator is empowered to perform functions of deterrence and compensation for consumer protection.[1705] In cases of 'mis-selling' of over-the-counter derivatives, for the purpose of deterrence, the regulator has mainly used financial penalties among many other coercive tools.[1706] However, as indicated in chapter Ⅲ, fine amounts are substantially short of the estimated commission earned by financial institutions through the penalized 'mis-selling' of over-the-counter derivatives.[1707] It is therefore questionable whether regulatory fines could sufficiently deter potential breaches.

In the domain of regulatory compensation, it is also difficult to say that all deserving consumers are compensated. First, as explained above, the regulatory system cannot detect consumer detriments that are not sufficiently significant for the regulator's intervention, and that are beyond the remit of the FOS.[1708] Further, it can be argued that even those detriments that have been detected by the regulator are not all compensated fairly and transparently, as the case below reflects.

[1703] Ibid; see also n1743

[1704] See House of Commons Treasury Committee, 'Conduct and competition in SME lending' *(*n976) para 173; see eg Liina Tulk, 'Interest rate swap litigation: strikeout for claimants following bank's victory', <http://mbmcommercial.co.uk/blogs/banking-disputes-blog/interest-rate-swap-litigation-strikeout-for-claimants-following-banks-victory/> accessed 15th March 2016

[1705] See p 84

[1706] See Table 1 at p 163

[1707] See p 172

[1708] See n1685, n1691, n1692

The FCA has, in principle, a policy to allow financial institutions to voluntarily compensate for consumer detriments when regulatory rules have been contravened, instead of getting involved to 'carry out extensive follow-up work'.[1709] In all sanctioned 'mis-selling' cases of over-the-counter derivatives where losses occurred to consumers, financial institutions awarded redress on a voluntary basis.[1710] The regulator, in most cases, didn't oversee the criteria and the process of determining eligibility for voluntary compensation,[1711] and the criteria were not publicized. Only in the 'mis-selling' case of IRHPs, which was of significant concern to the regulator, was it exceptionally involved in the direct extensive follow-up work of checking and creating compensation criteria.[1712]

As a result, consumers who suffered losses couldn't judge or monitor whether they were compensated fairly. It can therefore not be guaranteed that the violator's voluntary redress provides all aggrieved consumers with fair compensation. Consumers who are not compensated or not satisfied with the voluntary compensation can complain to the FOS.[1713] However, such compensation remains available only to eligible consumers. The only option for consumers who are not provided with either voluntary or FOS compensation is to approach the court for redress.[1714]

Another gap in regulatory compensation is its narrow scope. The compensation criteria for IRHPs, which the regulator co-created[1715] with financial institutions, revealed its intended coverage of regulatory redress. The criteria allowed for the review of the sales process only for 'non-sophisticated' and not for the 'sophisticated' consumers.[1716] As a

[1709] Financial Conduct Authority, 'The FCA's Approach to Supervision for fixed portfolio firms' (n1665) 3; Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) 279-285

[1710] See 4.1.1.2

[1711] Ibid; Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) 279-285

[1712] Financial Supervisory Authority, 'Letters to financial institutions related with IRHPs' (2013) <https://www.fca.org.uk/your-fca/documents/irhp-letter-january-2013> accessed 8th October 2017; Financial Supervisory Authority, 'Interest Rate Hedging Products: Pilot Findings' (n1067)

[1713] Financial Supervisory Authority, 'Interest Rate Hedging Products: Pilot Findings' (n1067) 13

[1714] See n1740

[1715] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 40

[1716] Financial Supervisory Authority, 'Interest Rate Hedging Products: Pilot Findings' (n1067) 13

result, 10,596 (34.3%) out of 30,804 consumers in IRHP's review couldn't qualify for the 'sophistication test'[1717].[1718]

The scope of non-sophisticated consumers is much narrower than the scope of 'retail clients',[1719] which is the class of consumers under the COBS's highest level of protection. This means that even if the COBS considered them as retail clients, they had no accessibility to regulatory compensation if they couldn't meet the conditions of the sophistication test. They had to rely on private law for redress, since they cannot qualify for FOS eligibility as non-sophisticated consumers—the sophistication test has tighter criteria than the FOS eligibility test.[1720] For instance, an SME with a £7 million turnover and a £4 million balance sheet is classified as a retail client by the COBS, but neither as a non-sophisticated consumer in the IRHPs review process, nor as an eligible consumer for the FOS. It can also be assumed that the regulator's intention to cover only non-sophisticated consumers for regulatory redress may be applied to financial institutions' voluntary compensation schemes in other cases, because financial institutions would follow the regulator's intention if there were no specific reason.

The final concern in regulatory compensation is the fact that the regulator may be vulnerable to external influence.[1721] The IRHPs' compensation process illustrated the financial regulator's exposure to pressure from politicians and other interest groups. The Treasury Committee of the House of Commons collected consumers' complaints about regulatory compensation for loss from IRHPs, and publicly criticised the regulator's compensation criteria and process, including the sophistication test, the complainant's access to review information, and the appeal process.[1722] Consumers of IRHPs also formed an interest group that put pressure on politicians to take action, and directly attacked the FCA's approach to IRHPs.[1723] In the other side, there was suspicion in the

[1717] See n973
[1718] Financial Conduct Authority, 'Aggregate position chart' (2015) <http://www.fca.org.uk/static/documents/aggregate-progress.pdf> accessed 5th May 2016
[1719] FCA Handbook, COBS, 3.5.2 (2), (3)R
[1720] See n973 and n980
[1721] See n184
[1722] House of Commons Treasury Committee, 'Conduct and competition in SME lending' (n976) 34-65
[1723] See http://bully-banks.co.uk/site/ accessed 15 May 2015

media that the government dismissed the former CEO of the FCA due to his tough position against financial institutions in dealing with various issues, including the IRHPs scandal.[1724]

This discussion illustrates that the level of sanctions by the regulator may not be sufficient for deterrence, and that some aggrieved consumers are left outside of the regulatory compensation's safety net as a result of the voluntary and opaque compensation scheme, and the regulator's narrow scope for redress. An actual case exposed the vulnerability of the regulator to pressure from outside. The next section examines whether private law complements such shortcomings and loopholes of regulation in its enforcement and intervention.

Private enforcement

Private law has two standards in dealing with claims of 'mis-selling' of financial products: (1) common law standards that apply to consumers who are non-private persons such as corporates, and (2) statutory regulation that applies to consumers who are private persons. This dichotomous application of standards is the result of the FSMA 2000, which entitles only the 'private person'[1725] with a 'right of action' to breach of statutory duty.[1726]

First, an examination is carried out into the treatment of non-private consumers—that is, corporate consumers who are not compensated by regulation—under private law in 'mis-selling' claims of over-the-counter derivatives.

Corporate consumers that cannot pass the 'sophistication test' are excluded from regulatory compensation, as seen above.[1727] Their cases, when brought to the court, are subject to common law and not bound by statutory regulation such as COBS. Section 5.2

[1724] See eg Lindsay Fortado et al, 'Martin Wheatley resigns as chief of Financial Conduct Authority', *Financial Times* (London, 15 July 2015) <http://www.ft.com/cms/s/0/61f867fa-2c76-11e5-8613-e7aedbb7bdb7.html#axzz3tMQBPsG4> accessed 1 April 2015; The City Grump, 'FCA CEO Martin Wheatley's removal could signal a new era in terms of investment', *realbusiness* (London 20 July 2015) <http://realbusiness.co.uk/article/30814-fca-ceo-martin-wheatleys-removal-could-signal-a-new-era-in-terms-of-investment> accessed 1 April 2015

[1725] See n1382

[1726] FSMA 2000, s138D

[1727] See n1716

evidenced that court rulings didn't consider rosy market forecasts, failure to explain risk, and failure to disclose fees—all of which are contraventions of the 'fair, clear and not misleading' rule of the COBS—as misrepresentations.[1728] Court rulings also indicated that financial institutions are not seen to have a duty of care as an advisor if the contractual terms disclaim provision of any advice; what regulation would see as unsuitable advice based on a 'de facto' advisory relationship is therefore not a breach of a duty of care in common law.[1729]

The *Nextia Properties Limited v National Westminster Bank Plc and The Royal Bank of Scotland Plc* serves as example.[1730] The plaintiff, a limited company in the real estate development business, suffered a significant loss following purchase of IRHP from the bank. Information isn't available about why the case was brought to court while regulatory compensation was in process, but it can be assumed that it was not eligible for compensation. Although it seems that its loss from IRHP could have been compensated under the regulatory 'compensation criteria',[1731] the court didn't accept any claims based on common law; it ruled that the non-disclosure of commission by the bank, which was seen as a breach of the 'fair communication' rule of the COBS[1732], was not a misrepresentation because it was an arm's length transaction. Further, the mismatching terms between the hedged loan and the hedging IRHP, which was seen as a contravention of regulatory rules,[1733] was not a breach of duty because the contract stated that assessing the IRHP's risk was the claimant's responsibility.[1734]

Second, consumers who are private persons can still be excluded from regulatory compensation due to, for example, large-sized[1735] investments and other unpublicized reasons, or can be unsatisfied with the result of 'voluntary' compensation. They could

[1728] See section 5.1.1.2
[1729] See n1458
[1730] [2013] EWHC 3167; see n1371
[1731] See n1480
[1732] Ibid
[1733] See n1365
[1734] See n1366; see [2013] EWHC 3167
[1735] For example, the size of IRHP should be below 10 million for the sophistication test in the IRHP scandals; Financial Services Authority, 'Interest Rate Hedging Products Pilot Findings' 10 available at < Interest Rate Hedging Products Pilot> accessed 9th January 2019

then bring their cases to court, with statutory regulation being applicable under Section 138D of the FSMA 2000. However, the likelihood of securing redress for this category of consumers in the court isn't promising. The biggest obstacle is to prove the causal relationship between the financial institution's contravention of regulatory duties and their losses in court.[1736] The regulatory compensation criteria also require causation between contravention and loss, but the requirements of causation in common law is much more 'precise'.[1737] Further, common law imposes the burden of proving causation on the claimant.[1738] For individual consumers, it is very difficult to prove that he/she would have acted differently 'but for' the financial institutions' breach.[1739]

Zaki & others v Credit Suisse (UK) Limited [1740] offers an example of private law's limitations in defending the loophole of regulatory compensation for consumers who are private persons. The plaintiff, a wealthy businessman, brought his case to court following a substantial loss from a structured capital at risk product (SCARP) that was recommended by the bank. Coincidently, the regulator found and sanctioned some regulatory breaches in the bank's SCARP business during its periodic onsite review.[1741] The bank agreed with the regulator to voluntarily compensate the consumers' losses caused by its breach.[1742] The fact that the plaintiff continued the litigation, even after voluntary compensation, showed that he was not redressed or not satisfied by the bank's compensation scheme (detailed information isn't available). Even though the court accepted the bank's breach of the COBS's suitability rules, it denied the existence of a causal relationship between the regulatory breaches and the plaintiff's loss, and so ruled no need for compensation.[1743]

[1736] Financial Services Authority, 'Joint Committee on the Draft Financial Services Bill Memorandum from the Financial Services Authority' (2011) 8, <www.fsa.gov.uk/pubs/other/pls.pdf> *accessed 16 January 2016*

[1737] See 5.1.2.3; Stephen D. Sugarman (n 1514) 141

[1738] Simon James (n 423) 159; Olha O. Cherednychenko, 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (2014) 10.4 *European Review of Contract Law* 476, 492

[1739] Olha O. Cherednychenko 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (n1738) 492

[1740] [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583

[1741] See n969

[1742] Financial Supervisory Authority, 'FINAL NOTICE to Credit Suisse (UK) Limited' (2011)

[1743] See n1407

This discussion reveals that private law didn't succeed in providing redressal, whether based on common law or regulatory rules, for aggrieved consumers who were not compensated by regulation for reasons such as financial institutions' voluntary compensation scheme, opaqueness of the compensation criteria, and consumers' narrow scope for compensation. It further shows that private law cannot supplement the insufficient deterrence function of regulation.[1744] In essence, private law fails to compensate for the loopholes of regulation in its enforcement and intervention to effectively achieve both deterrence and compensation.

5.3.1.4 Summary

The previous sections illustrated that the complementary interplay between private law and regulation in the UK has not been effective in dealing with 'mis-selling' of over-the-counter derivatives. Julia Black described this lack of interplay in the financial services law as 'separate rooms' where the two institutions rarely interacted, but lived 'in an uneasy coexistence'.[1745] The key causes of such ineffective complementarity are, first, the difference in standards of the two institutions[1746] and, second, the difficulty of proving causation[1747] between breach of regulatory duty and consumer detriment in private law.

5.3.2 South Korea

In South Korea, private law and COB have separate functions with the same norm.[1748] The court and the regulator are both bound by the FISCM Act's COB. However, the regulator is given the authority only to take disciplinary action on regulated financial institutions, without any role in redressal. The interplay between South Korea's private law and COB is discussed below.

[1744] See p268

[1745] Julia Black, 'Law and Regulation: The Case of Finance in Regulating Law' in Christine Parker, *Regulating Law (*OXFORD 2005) 43-49; see also Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894) location 6300

[1746] Ibid p45

[1747] See n1743; see also George Walker, Robert Purves, and Michael Blair QC (n 439) para 12.06

[1748] See 5.2.2

5.3.2.1 Standard setting

Section 1.3.2.3 stated that regulation's rapid response to changes in the environment is an advantage compared to that of private law. However, South Korea's COB in financial services has generally been an exception to this statement. For example, the court established through case law the 'duty to protect customers'—which is conceptually the same as the suitability rule or duty to explain—before those duties were promulgated as a statutory regulation. This exceptional situation is explained by the superiority of private enforcement to monitor potential breaches.[1749] In South Korea, disputes over 'mis-selling' of financial products have been emerging since the 1990s with the financialization of local economy; in those days, such disputes were not substantial enough to attract the regulator's limited attention and resources. This situation can be explained by the limited power to redress by the regulator and the alternative dispute resolution.[1750] Individual dispute cases couldn't reach the regulator due to its lack of resolution power.

The court's proactive and flexible approach in the face of new types of conflicts could constitute another explanation. When an alleged 'mis-selling' case was brought to court, according to the existing 'principle of self-responsibility' [1751] for financial investments, the consumer's probability of being granted a compensation order was low. However, in dealing with new types of disputes over 'mis-selling' due to unsuitable advice and insufficient explanation, the court referenced similar cases in the US and Japan and established a new 'duty to protect customers'.[1752]

This uncommon phenomenon shows South Korea's late responsiveness in the legislation of regulation. As explained in chapter Ⅲ, 'the principle of pre-formulation of state actions by legislation' requires that key regulatory requirements must be stipulated in the Act,

[1749] See 5.3.2
[1750] See p268
[1751] See p268
[1752] Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender]* (n924)

and ratified by the National Assembly. Such constitutional constraints present an obstacle to swift promulgation of the conduct of business duties.[1753]

The court's establishment of the 'duty to protect customers' without legislation shows complementary interplay between private law and public regulation. The FISCM Act enacted duties similar to private law's 'duty to protect customers' and minimised any possible dissonance between the two institutions by clarifying that the breach of these duties results in liability for detriments.

The FISCM Act defined detailed procedures for complying with the suitability rule and duty to explain, and shaped private law's vague 'duty to protect customers'. The court, through adjudication of each individual case, showed the extent of duties required by the vague and general requirements of the COB in specific circumstances, and so performed its residual rule-making function[1754].

5.3.2.2 Enforcement and intervention

A contrast exists in the approach of enforcing the COB between the South Korea's regulator and the court. The regulator is focused on assessing compliance with the procedural rules and sanctioning breaches, rather than compliance with the spirit of the suitability rule and duty to explain.[1755] On the other hand, the court considers the procedural requirements of regulation as one of many considerations, and doesn't see it as central to restorative justice.[1756] Instead, it analyses of each case in depth to assess compliance with the core spirit of the COB. The court, in applying the vague and general COB to idiosyncratic cases, makes a judgement about the extent of duties that inevitably occur. Determining compliance with the spirit of the COB in each case is time consuming.[1757] The level of consumer knowledge and experience must be determined,

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[1753] In fact, the South Korean regulator defined the duty of suitability and explanation in its tertiary rules which didn't have official binding effects, before the FISCM Act's enactment. See Kwon Soon Il, *증권투자권유자책임론 [Responsibility of Financial Investment Recommender] (*n924)

[1754] Katharina Pistor and Chenggang Xu, 'Incomplete law' (n114) 946

[1755] See 4.2.2 and 4.2.3

[1756] See 5.2.1.2

[1757] Eilis Ferran, 'DISPUTE RESOLUTION MECHANISMS IN THE UK FINANCIAL SECTOR' (2002) 32-33 available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=298176> accessed 12th July 2017

and all communication between the consumer and the sales representatives of the financial institution must be analysed.[1758] This obviously requires much more effort than to confirm procedural requirements, such as whether a form has been signed. For the regulator, who must prove its performance[1759] at both the individual and the agency level, it is very "inefficient" to assess whether the spirit of the COB has been followed in individual cases. However, the court, which must deal with sharp conflicts of interest between the plaintiff and the defendant, is able to and should perform a deep examination to assess compliance with the spirit of the regulation.[1760]

In this regard, it can be said that the court's enforcement of the 'substance' criteria complements the regulator's process-focused enforcement. Therefore, when the regulator needs to enforce on substance, for example when the Conflict Adjustment Committee must propose a compensation plan for a large-scale 'mis-selling' scandal, it can assess compliance with the regulatory spirit by applying the decision criteria used by the Court in its adjudication.

[1758] Geoffrey B. Goldman, '"Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators" Punish the Wall Street Hounds of Greed"?' (1995) 95 *Colum. L. Rev.* 1112, 1118-1119

[1759] See p 197

[1760] See p 32

Conclusion

This chapter examined how private law and COB have interplayed by analyzing cases adjudicated by the courts in the UK and South Korea. The most striking characteristic of the UK framework is the dissonance in requirements and in causation assessments between the private law and COB. The UK's private law recognizes transactions of over-the-counter derivatives as arm's length contracts. Therefore, the contract is the most important basis for determining whether there was mis-behaviour. However, because the COB has mandatory requirements that over-ride the contract, those requirements are applied to financial institutions irrespective of what is in the contract. With respect to causality analysis, private law requires tight tests to be passed for causality to be established but the regulator basically determines whether there is a fair and recognizable causality between the misbehaviour and loss. Due to such dissonance in requirements and causation test, situations arise where COB determines certain acts to be subject to sanctions while private law does not accept that compensation is required. With such cases, it is difficult to say that there is harmonious interplay between private and public enforcement. Rather, the different judgments made by regulation and private law about the same act create market confusion.

On the other hand, in South Korea, because COB is stipulated in the primary legislation and so binds on the court, the same statutory rules are applied to 'mis-selling' disputes in private law and regulation. However, the approach taken by the regulator and the court to 'mis-selling' cases is different. As shown in chapter IV, the South Korean regulator's enforcement approach focuses more on breaches of procedures than substance. But the court places more importance on the substance of the suitability rule or duty to explain in its adjudications. This reflects the difference in their roles: the regulator having to handle many cases within a limited time using a standardized approach and the court having to decide the rights and liabilities of two counter-parties that have sharp conflicts of interests. It appears that private enforcement focusing on substance of regulation is complementing public enforcement which focuses on procedures.

The analysis of private enforcement of the two countries in this chapter provides the answer to the fourth research question[1761].

[1761] How did South Korea and the UK design the relationship between private law and the COB and as a result, do public enforcement and private enforcement interplay effectively in the COB regimes of the two countries?

CHAPTER VI. CONCLUSION AND RECOMMENDATION

6.1 Outline of thesis

Chapter I has explained the objective and research framework of the thesis. The objective of this thesis has been to present a critical analysis of South Korea's COB regime for preventing 'mis-selling' of over-the-counter derivatives, then to assess its effectiveness. To achieve the objectives, the study adopted a comparative-analytical methodology to compare the UK and South Korea's COB regimes. Using this methodology, the South Korea regulatory regime was considered in a wider context, and subjected to deeper scrutiny than it has been hitherto. For this, the UK and South Korea's regulatory regimes were compared in terms of "law on the books" (statutory regulation) and "law in action" (enforcement).

A regulatory regime should pursue stability and rationality, which can be contradictory values. The thesis argues that both stability and rationality must be harmoniously pursued for the regulatory regime to obtain effectiveness. In comparing how stability and rationality is pursed by the two countries, the thesis selected as subjects of comparison: 1) rule-making method, 2) rule-enforcing strategy, and 3) interplay between public enforcement and private enforcement.

Before the comparative study began, chapter Ⅱ provided an explanation about why over-the-counter derivatives have higher consumer dependence on the seller and so is more vulnerable to mis-selling. The first cause of higher vulnerability to 'mis-selling' was shown to be the asymmetry of information and knowledge between financial institutions and consumers, which results in consumer dependency on dealers. It was explained that over-the-counter derivatives are usually proprietary products that are designed by the seller and so the imbalance of information and knowledge is more severe than other generic financial instruments. Secondly, the high leverage of over-the-counter derivatives can result in significantly bigger losses compared to losses from other generic

instruments without leverage. Lastly, the substantial commission income of the financial institution and generous financial bonuses for salespersons from selling over-the-counter derivatives contributed to a favourable environment for 'mis-selling'. These characteristic of over-the-counter derivatives answers the first research question.[1762]

Chapter III evaluated the effectiveness of COB "on books" through a comparative study of rule-making between the UK and South Korea. Based on the analysis of the two countries' rulebook of COB, it was found that they have very different rule-making approaches. As the name PBR[1763] suggests, the UK formulates rules as purposive and vague rule-types. To complement uncertainty, a weakness of such rule-types, the UK adopted Guidances consisting of informative and non-binding rule-types. However, in South Korea all rules are formulated with precise and clear rules. The chapter showed that the precise and clear rules of South Korea were partly due to constitutional constraints but also because of the tendency of the South Korean administration to put too much importance on the regulatory regime's certainty and stability.

The contrasting rule-making styles of the two countries created different regulatory outcomes. In South Korea, the precise and clear rules created the problem of rigid interpretation and application of "letters" of rules. This has led to results that are distant from the objective of the regulatory rule, or in other words, a decline in the rationality of the regulatory regime. In the UK, by using various rule-types such as Principles, Rules and Guidances, they created a foundation where the regulatory regime can pursue stability and rationality (although, a good rulebook does not necessarily guarantee the achievement of the two values). This evaluation of rule-making in the two countries partly provides an answer to the third research question.[1764]

[1762] What are the characteristics of over-the-counter derivatives which make them more vulnerable to "mis-selling" than other financial instruments?

[1763] Principle-Based Regulation

[1764] What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?

The chapter also explained the ineffectiveness of South Korea's COB regime based on the compatibility of COB with South Korea's macro and micro circumstances. In conclusion, it was shown that although the South Korean economy's financialization (macro circumstances) needed the transplant of COB, South Korea's command-and-control style regulatory culture (micro circumstances) did not fit with COB, which is a general standard rule.

Chapter IV analysed the public enforcement of the COB regimes of South Korea and the UK. The UK's public enforcement by the regulator is a compliance-focused approach. This approach relies on the goodwill of the management and employees of financial institutions and focuses on helping to improve the internal control system to facilitate compliance. However, as the UK admitted, the compliance-oriented enforcement strategy on its own failed to internalize the regulatory objectives into the norms of the regulated. Based on such failure, the UK has adjusted its stance one-click toward a deterrence-focused enforcement by adopting the SMCR, which makes individuals at financial institutions more accountable.

South Korea has experienced failure in its deterrence-focused enforcement strategy. South Korea transplanted general standard rules such as the suitability rule and duty to explain but the country's legalistic approach in enforcement was not appropriate for enforcing such general standards. South Korea's deterrence-oriented and legalistic enforcement focused on compliance, not of the spirit but the process. Sanctions on breaches of processes set by the proxy rules made the regulated also focus on only complying with the "letters of rules". The unreasonable situations, where the COB regime has produced results distant from the objective, have breeded hostility and ignorance towards it. Chapter IV, which explained the causes of the failure of the two countries' enforcement strategy, is the answer to the third research question.[1765]

[1765] What rule-making and rule-enforcing approaches in COB did South Korea and the UK take and how did those approaches shape the attitudes of the regulator and the regulated and furthermore, what impact are they having on the effectiveness of the COB regime?

Then Chapter IV proposed a balanced enforcement approach to address the regulatory failures in the two countries. A balanced enforcement approach involves the following: first, proactive sanctions with sufficient deterrent effects against regulatory breach; second, being outcome-focused, and 3) responding and adapting to its performance and changing environments.

Chapter V examined the interplay between private law and COB by analysing the cases adjudicated by the courts in the two countries. The striking characteristic of the relationship between the UK's private law and COB is dissonance in their requirements and causation assessments. The UK's private law recognizes transactions of over-the-counter derivatives as arm's length contracts. Therefore, the contract is the most important basis for determining whether there was mis-behaviour. However, because the COB has mandatory requirements that over-ride the contract, those requirements are applied to financial institutions irrespective of what is in the contract. With respect to causality assessment, which looks at whether the financial institution's misbehaviour caused a consumer's loss, private law requires very tight tests to be passed for causality to be accepted but the regulator basically determines whether there is a fair and recognizable causality between the misbehaviour and loss. Due to such dissonance in requirements and causation assessment, situations arise where COB determines certain acts of a financial institution to be subject to sanctions while private law does not accept that compensation is required. With such cases, it is difficult to say that there is harmonious interplay between private and public enforcement. Rather, the different judgments made by regulator and the court about the same act is creating market confusion

In South Korea, because COB is adopted through legislation and so binds the court, the standards that apply to 'mis-selling' disputes are the same between private law and regulation. However, the approach taken by the regulator and the court to each 'mis-selling' case is different. The South Korean regulator's enforcement approach focuses more on breaches of procedures than substance. But the court adopts the substance of the suitability rule or duty to explain as the reference for its adjudications. This difference

reflects the difference in the roles: the regulator having to handle many cases within a limited time using a standardized approach and the court having to decide the rights and liabilities of two counter-parties that have sharp conflicts of interests. It appears that private enforcement focusing on substance of regulation is complementing public enforcement which focuses on procedures. The analysis of private enforcement of the two countries in this chapter provided the answer to the fourth research question.[1766]

6.2 Key findings

6.2.1 Regulation "on the books"

It has been illustrated by the UK and South Korean case studies in this thesis,[1767] as well as numerous other studies,[1768] that vague and purposive rules are more effective for achieving the regulatory goals with minimal undesirable results.

This is, first, because the rule-makers cannot anticipate all possible malpractices in the financial services industry in advance, due to the idiosyncratic situations and fast-changing business practices.[1769] In addition, the inherent under-inclusiveness of specific and precise rules of the COB could push risk-averse rule-makers towards excessively over-inclusive rules, such as zero-tolerance rules.[1770]

[1766] How did South Korea and the UK design the relationship between private law and the COB and as a result, do public enforcement and private enforcement interplay effectively in the COB regimes of the two countries?

[1767] See V.1 and V.2

[1768] For example, see Christine Parker, 'Reinventing regulation within the corporation: compliance-oriented regulatory innovation' (n1304) 547; see also John Braithwaite, 'The politics of legalism: Rules versus standards in nursing-home regulation' (1995) 4 *Social and Legal Studies* 307; see also Robert Baldwin, Martin Cave, and Martin Lodge, 'Introduction: Regulation – The Field and Developing Agenda' in Robert Baldwin, Martin Cave, and Martin Lodge, *The Oxford handbook of regulation* (Oxford University Press, 2010) 6-8; see also Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997)

[1769] See p 1 7 ; See also Neil F. Johnson, Paul Jefferies, and Pak Ming Hui, *FINANCIAL MARKET COMPLEXITY* (OUP Oxford, 2003) 4; Cristie L. Ford, 'New Governance, Compliance, and Principles-Based Securities Regulation' (n1279) 2-3

[1770] See p 1 3 5 ;

Second, specific and precise rules could render the regulatory regime, including the enforcement system, to adversarialism and legalism.[1771] The regulator and the regulated could forget the regulatory purpose and blindly enforce and comply with the proxy rules under this system.

However, a rule-making system with vague and purposive rules could only work on a foundation of trust among the rule-maker, the enforcer, and the regulatee.[1772] Without trust, vague and purposive rules would merely be announcements that couldn't provide any actionable guidance, resulting in 'just empty words'.[1773] Trust between the actors of the regulatory space is the belief that other actors have a commonly shared understanding of the vague and purposive rules, and will act based on the understanding.[1774] Consistent with all human affairs, the development of trust through accumulation of successful conversation and cooperation is time-consuming. Therefore, in jurisdictions that are accustomed to a command-and-control regulatory culture, with its usual lack of experience in conversation or cooperation between the regulator and the regulated, the regulated should be provided with sufficient advice about implementing vague and purposive rules. Above all, the regulator must convince the regulated of its trustworthiness through its actions. The regulator's unreasonable enforcement driven by a political storm, or use of the benefit of hindsight to sanction for the sake of sanctioning, are illustrative of actions that undermine the regulated community's trust.

For a rule-making system with vague and purposive rules to work, financial institutions should enhance their capability to comply with vague and purposive rules. They have to demonstrate their capability to establish their own internal compliance system and make business decisions based on vague and purposive rules. In addition, they must be

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[1771] See p196; see also Nicola Lacey, 'The jurisprudence of discretion: escaping the legal paradigm' (Clarendon Press, 2002) 362; see also Gunther Teubner, 'Juridification' Julia Black, *Rules and regulators* (Clarendon Prss Oxford, 1997) 374-405

[1772] See p158

[1773] Cristie L. Ford, 'New Governance, Compliance, and Principles-Based Securities Regulation' (n1279) 50-52

[1774] See p156

prepared to invest more resources than under clear and precise rule-making systems.[1775] Learner's comment about rule-making almost a century ago still applies to the COB.[1776]

6.2.2 Regulation "in action"

Public enforcement

The UK and South Korea chose symmetrical enforcement strategies. In general, the UK chose compliance-oriented enforcement—particularly before the global financial crisis—and South Korea chose deterrence-oriented enforcement. However, both countries have failed to achieve the outcome pursued by the COB, and both adjusted the enforcement strategy.[1777] The case studies of the two countries and other empirical and theoretical studies by numerous scholars showed that a single-minded regulatory enforcement strategy is inferior to a balanced strategy that combines the two strategies to achieve compliance by the regulated.[1778]

Exogenous factors largely impact the regulator's choice of enforcement strategy. First, the rule-making system influences the enforcement strategy.[1779] A regulatory regime with a specific and precise rule-making system has a high propensity towards a deterrence-oriented enforcement strategy.[1780] As the regulatory requirements are already precise and clear, there would not be a strong need for compliance-supportive enforcement of

[1775] Christopher Hodge, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics (*n894), location 9285; see also Cristie L. Ford, 'New Governance, Compliance, and Principles-Based Securities Regulation' (n1279) 38

[1776] Max Learner, 'The supreme court and American capitalism' (1933) 42.5 *The Yale Law Journal* 668, n8, where the author said that "It is generally accepted that one of the essential elements of law is certainty, and that it is especially essential for the development of capitalism. It encourages accumulation and investment by certifying the stability of the contractual relations. But it is to be conjectured that a speculative period in capitalist development thrives equally or better on uncertainty in the law. And in periods of economic collapse the crystallized certainty of capitalist law acts as an element of inflexibility in delaying adjustments to new conditions."

[1777] See V.3

[1778] See n1262 and n1264

[1779] See p 1 9 6

[1780] Ibid

the regulator. Instead, the regulator is likely to focus on the detection and sanction of breaches of specific and precise rules.[1781]

Second, a regulatory enforcement style is significantly influenced by the political dynamics among constituents in the regulatory space.[1782] With respect to regulation and its enforcement, conflicting interests could exist among the regulator, the regulated, and politicians in the parliamentary committee.[1783] The enforcement strategy is the compromised result of the convergence of conflicting interests of different actors in the regulatory regime. If the regulated has a strong political influence—for example if the financial industry comprises a high proportion of the whole economy and is a big donator of political funds[1784]—the regulator's enforcement style is likely to tend towards minimising financial institutions' compliance cost. Financial institutions don't always prefer a compliance-oriented enforcement style. A strategy based on minimising their compliance cost could vary depending on the applicable issue and circumstances. As an example, the regulated community's strong resistance terminated the UK regulator's culture review, which represented compliance-oriented enforcement.[1785] The South Korean deterrence-oriented enforcement, focused on individual employee sanctions, enabled minimal entity-level compliance cost for financial institutions.[1786]

Enforcement and compliance are two sides of the same coin. The regulated select a compliance strategy in response to the regulator's enforcement approach.[1787] Therefore, a once effective enforcement approach or tool could become obsolete due to a change in the regulated's compliance strategy. The UK regulator's 'light touch' enforcement approach of ensuring market autonomy while maintaining discipline could be considered

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[1781] See p 196

[1782] See p 197

[1783] John Armour, *(*Oxford University Press, 2016) location 18411 (kindle edition)

[1784] See p 198

[1785] See p 222

[1786] See p 203

[1787] Iain Macneil, 'Enforcement and Sanctioning' (n1138)

as having lost effectiveness, as the occasional behaviour of evading the regulator's trust spread to the rest of the regulated community.[1788]

The enforcement strategy must be continuously adjusted based on close monitoring of the regulated's compliance attitude and regulatory outcome. The regulator, the regulated, and even politicians could all fall into short-termism, attempting to achieve results too quickly.[1789] Actors in the regulatory space should consider their different interests and continuously collaborate towards an enforcement strategy that could achieve the regulatory outcome.[1790] Examples of this are: (1) the manner in which the UK regulatory regime, with its entity-level reliance on sanctions, adopted the SMCR for regulatory liability on individuals, and (2) the movement to empower the South Korean regulator, with its employee-level sanctions, to charge stronger entity-level financial penalties.[1791] A regulatory regime's response to the assessment of regulatory outcome should not simply be about the regulatory tool, but also include attempts to reform the overall enforcement and rule-making strategy. The UK has shown such continuous and reformative responsiveness in its regulatory system.[1792]

Private enforcement

For realisation of the complementary interplay between the two institutions, a robust institutional design of the relationship is necessary. Considering that regulation was created to address failures of the market and of private law, it is natural for the COB to diverge from private law's traditional and conventional principles.[1793] However, if this inherent dissonance isn't harmonised, the diverging norms of private law and COB could be counter-effective. Harmonisation could be facilitated through legislation that forces

[1788] See p 2 0 8

[1789] See James C. Cooper and William E. Kovacic, 'Behavioral economics: implications for regulatory behavior' (n1243) 46

[1790] Christopher Hood, *The blame game: Spin, bureaucracy, and self-preservation in government* (Princeton University Press, 2010) 178

[1791] See 4.3.2

[1792] See p 1 5 2 and p 1 7 5

[1793] See p268

the court to use the COB as a decision-making reference in its adjudication. Another method is that the court voluntarily and proactively accepts the COB as decision criteria.

The UK chose a compromised approach, which grants the right of action against regulatory breach to only a part of the investors by legislation; this is an example of institutional design that obstructs the interplay between private law and the COB. Such a partially allocated right of action prevented the court from voluntarily acknowledging or applying the regulation in private law, and hindered the complementary interplay between private law and the COB.[1794] The dissonance in orders from the two institutions resulted in a lack of ethical norms in the financial market, driving an opportunistic and technically defensive attitude in consumers and financial institutions.[1795] Depending on the tradition of the legal system in each country, the harmonisation between private law and the COB may be implemented differently; however, the UK example demonstrates the need for design of the relationship between the two institutions to prevent dissonance in their respective norms.

6.3 Recommendations

6.3.1 UK

The UK's regulatory rulebook seeks both certainty and flexibility through different types of rules.[1796] The 'Rule', which has a binding effect, is written in vague and purposive language, and the lack of certainty and predictability is complemented with 'Guidance' written in specific and precise language with no binding effect.[1797] Through many financial scandals and crises, the UK retains a rule-making system with general standards.[1798] Policy makers and regulators understand the limits of specific and precise

[1794] See p268
[1795] See p268
[1796] See p 8 8
[1797] Ibid
[1798] See p 1 8 0 ; the open textured principles of financial regulation and its enforcement have raised the concern of damaging the spirit of 'rule of law' in the UK. For example, see Eilis Ferran, 'Capital Market Competitiveness and Enforcement' (2008) available at SSRN: <https://ssrn.com/abstract=1127245>, accessed 16th January 2017; see also Martin Lodge, 'Accountability and transparency in regulation: critiques, doctrines and instruments' in Jacint Jordana, and David Levi-Faur (eds), *The politics of regulation: institutions and*

rules well, partly from unsatisfactory results from those rules before the New Settlement.[1799]

The UK's public enforcement, while assessing its performance, has been evolving in response to changes in the financial market environment and the attitude of the regulated.[1800] The UK regulatory regime can be considered as having a high level of responsiveness. Experimenting various enforcement strategies, the UK policy maker and regulator have recognised the problematic culture of the financial services industry as the root cause of continuous malpractice. They are in the process of strengthening personal regulatory liability as a way of improving the 'bad culture'.[1801]

This thesis argues that one of the biggest reasons for a defective culture in the financial services industry is the dissonance of orders between private law and public regulation.[1802] Without a socially agreed norm in doing financial instrument transactions, placing heavy personal liability on regulatory breach alone will not change unethical culture. Rather, there is a higher possibility that it could bring creative compliance and ignorance of regulation. This thesis therefore recommends that the UK regulatory regime's first priority for reform is harmonisation of the dissonant orders between private law and public regulation.

6.3.1.1 Regulation as the minimum requirement

General direction

Harmonisation isn't substituting private law with regulation, or vice versa. The sources of the dissonance between regulation and private law, as explained in chapter V, are that both institutions have their own history of standard developments to achieve different

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regulatory reforms for the age of governance (Edward Elgar Publishing 2004) 125; see also Paul Graig, *Administrative Law (*Sweet & Maxwell, 2016) location 19070-19106; see also Jonathan Fisher and Julia Black, 'Law and Regulation in Global financial markets' (2010) 4 *Law & Fin. Mkt. Rev.* 346, 358

[1799] See n903

[1800] See p 175

[1801] See p 186

[1802] See section 5.1.3.1

functions and goals.[1803] Complementary interplay should be pursued while preserving the framework of each institution.[1804]

In order to do so while acknowledging the merits of each institution, it is recommended that regulation be positioned as the minimum requirement in private law. This means that private law will see a breach of regulatory duty as negligence per se, but can also impose more requirements on financial institutions than what regulation requires.[1805] However, note that even if a breach of regulatory rules is seen as negligence, liability is relevant only when it satisfies the causation[1806] between negligence and detriment. For instance, breach of the statutory rule of maintaining promotion records,[1807] which doesn't have any causal effects in terms of consumer detriments, should not result in imposing civil liability on the financial institution, apart from a regulatory sanction.

If set as the minimum requirement, regulation would become the 'baseline' of private law;[1808] however, 'regulatory compliance defence',[1809] which means that compliance with regulation will preclude any liability in private law, would not be admitted.[1810] Positioning regulation as the minimum requirement in private law is persuasive, since regulation was devised in the first place to alleviate market failures that couldn't be solved by private law.[1811]

Instituting regulation as minimum requirement in private law has substantial advantages. First, private law can develop its own knowledge and experience incrementally on top of regulation, and will be capable of solving regulatory failures due to obsolete regulation.[1812] Even though a swift response is strength of regulation, some time lag is

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[1803] See section 5.2.1

[1804] See Steve Hedley, 'Looking Outwards or Looking Inward? Obligations Scholarship in the Early 21st Century' in Andrew Robertson and Hang Wu Tang (eds), *The goals of private law* (Bloomsbury Publishing 2009)

[1805] See Susan Rose-Ackerman, *Rethinking the progressive agenda* (n1318) 124

[1806] See 4.3.2

[1807] COBS 4.11.1R (1)

[1808] Ibid

[1809] American Law Institute, *Enterprise Responsibility for Personal Injury* (1991) 87-89

[1810] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,320-321

[1811] Patrick S. Atiyah, *The rise and fall of freedom of contract* (Vol. 61. Oxford: Clarendon Press, 1979) 703; Fabrizio Cafaggi (n 1608) 192-193

[1812] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,322; see 4.4.3.2; THIRUVALLORE T. ARVIND and JOANNA GRAY, 'The Limits of Technocracy: Private Law's Future in the Regulatory State' (n1607)

inevitable; rule-makers are sometimes not able to recognize the gaps that it creates.[1813] In this regulatory vacuum, private law could prevent unfair outcomes in 'mis-selling' disputes of financial products by adding its own requirements, since it is more apt to make subtle changes in its ruling.[1814] Private law could also solve not only the obsoleteness of regulation, but also the limit of rigid ex-ante regulatory requirements. Regulation cannot anticipate all the possible wrongdoing, and unconditional application of regulatory rules might sometimes lead to an unfair result.[1815] For instance, by the COBS's information disclosure rule,[1816] a financial institution that doesn't provide any personal risk warning to exceptionally vulnerable consumers, such as very old retired people, isn't liable for any breach of regulatory requirements only if it gives a risk warning in a tiny-printed standard form.[1817] Private law could ameliorate the regulatory failure from the rigidity and homogeneity of regulatory requirements.

Second, it promotes interaction between the two institutions. It will lead the court to take a close look at how the regulator interprets and enforces regulatory rules,[1818] and to develop its own ways of integrating regulatory rules with traditional private law.[1819] On the other hand, the regulator, which concentrates on widespread detriment to a large group of consumers, could learn from the court's consideration of 'idiosyncratic factors' and better apply regulatory rules to individual cases of low homogeneity.[1820]

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p11; see also Vanessa Mak, 'The 'Average Consumer' of EU Law in Domestic and European Litigation' (n1317) n36

[1813] Katharina Pistor and Chenggang Xu, 'Incomplete law' (n114) 955

[1814] Olha O. Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (2015) 21.4 *European Law Journal* 500, 515

[1814] Alaistar Hudson, *Law of Finance* (n 413) para 1-78

[1815] Olha O. Cherednychenko, 'Public regulation, contract law, and the protection of the weaker party: some lessons from the field of financial services' 22.5 (2014) *European Review of Private Law* 663, 673

[1816] COBS 2.2.1R (2)

[1817] Olha O. Cherednychenko, 'Public regulation, contract law, and the protection of the weaker party: some lessons from the field of financial services' (n1815) 673

[1818] Olha O. Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (n1814) 515

[1819] Thiruvallore T. Arvind and Jenny Steel, 'Legislation and the Shape of Tort Law' in Thiruvallore T. Arvind, *TORT LAW AND THE LEGISLATURE* (2012) n63 in Chapter I

[1820] Fabrizio Cafaggi (n 1608) 242; See Alaistar Hudson, 'The synthesis of public and private in finance law' (n1317) 5.B.; THIRUVALLORE T. ARVIND and JOANNA GRAY (n 1607) n14

The key question is, then, how to ensure the positioning of regulation as the minimum requirement in private law. The court could refer to regulation as appropriate when deciding liability; however, leaving this to judicial discretion cannot ensure harmonized integration.[1821] In practice, the court seems reluctant to consider regulation in deciding liability.[1822] For legal certainty and consistent complementary interplay, an express statutory provision stipulating regulation as the minimum requirement in private law is necessary.[1823]

Implementation

The general direction for ensuring more complementary interplay between private law and regulation is proposed above: an express legislative provision stipulating regulation as the minimum requirement in private law for the court to take it into account in its decisions. Section 138D of FSMA 2000 is an important statutory tool through which to realize this general direction. The origin, meaning and drawbacks of section 138D are examined below, and an improvement plan is recommended.

(1) Brief history of legislative framework for private enforcement of regulation

Section 138D of the FSMA 2000 is the express provision that gives some consumers a 'right of action' for breach of regulatory duty by financial institutions.[1824] This provision has a long history, starting from Section 62 of the FS Act 1986, which was the first legislative attempt in financial services law to confer a 'right of action' on consumers who suffered loss from contravention of regulatory rules.[1825] It is noteworthy that Section 62 provided a 'right of action' for all persons, including companies, if they suffered losses as a result of regulatory contraventions.[1826] However, it was never put into

[1821] Law Commission, *Fiduciary Duties and Regulatory Rules* (n1483) para 1.10; Keith Stanton, 'Legislating for Economic Loss' in Thiruvallore T. Arvind, *TORT LAW AND THE LEGISLATURE (*Bloomsbury Publishing, 2012) 269-284

[1822] Law Commission, *Fiduciary Duties of Investment Intermediaries* (n1484) para 1.60; Alaistar Hudson, 'The synthesis of public and private in finance law' (n1317)

[1823] Law Commission, *Fiduciary Duties and Regulatory Rules* (n1483) para 6.2; Keith Stanton, 'Legislating for Economic Loss' (n 1821) 269-284

[1824] FSMA s138D

[1825] Department of Trade and Industry, *Defining the private investor: a consultative document (*n1385) 4

[1826] Ibid

force.[1827] After six months of suspension, it was overridden by Section 62A, which restricted the range of persons conferred the 'right of action' to the 'private investor' [1828], a term defined by secondary legislation[1829]. Section 62A of the FS Act descended to Section 150 and to the current Section 138D of FSMA 2000 without substantial modifications ('private investor' was changed to 'private person').

Government (Department of Trade and Industry) revised Section 62 with Section 62A for two reasons. First, it was concerned that Section 62 would entail vexatious lawsuits in the financial services sector. [1830] It sympathized with the concern of large financial institutions [1831] that Section 62 would be misused to initiate 'strategic' lawsuits by competitors.[1832] Second, it alleged that Section 62 would lead rule-makers—the statutory regulator and self-regulatory organizations at that time—to develop rulebooks that are too descriptive and detailed, rather than precise, for lawsuits. These rulebooks would be too complex to understand, too costly to comply with, and too rigid and descriptive to improve the actual level of consumer protection.[1833]

In spite of the drastic reduction of its ambit, Section 62A has some important meanings. It was the first provision in force, which tried to utilize private enforcement for public regulation in the UK's financial services law. This was a progressive step towards better interplay between private law and public regulation. It created the legislative foundation for regulation to function as private law's minimum requirement, because the claimant could receive compensation at least based on breach of regulation, and the court could add additional requirements beyond regulatory rules[1834].

[1827] Ibid
[1828] Ibid
[1829] The Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991, SI 1991 No 486
[1830] Department of Trade and Industry, *Defining the private investor: a consultative document (*n1385) 4
[1831] Ibid
[1832] Ibid
[1833] Ibid, 5
[1834] Peter Cane, 'Tort law as regulation' (2002) 31 *Comm. L. World Rev.* 304,321

Further, it secured the flexibility[1835] of the ambit of its application by delegating the power of defining the range of persons entitled to employ this 'right of action' to secondary legislation to be promulgated by government[1836]; thereafter, government has been able to modify the range of consumers conferred a 'right of action' in line with changes in financial environments.

On the other hand, Section 62 limited a 'right of action' to a section of consumers only. As such, it has not only constrained complementary interplay but also entrenched the dissonance between private law and regulation. *Grant Estates Limited v The Royal Bank of Scotland* shows the unintended consequences of this restriction.[1837]

The court interprets the provision of a 'right of action' to private persons only that regulatory rules should not be applied to non-private persons in private law; however, this was not the intention of Section 62A. The Department of Trade and Industry stated that 'Breach of statutory provisions always raises possibility of a "right of action", and s62 didn't therefore necessarily create a new right'.[1838] Section 62A intended to express clearly that some consumers had a 'right of action', while not disclaiming the general right of action for regulatory breach of other consumers in private law.[1839] However, the legislative provision with the purpose of confirming a 'right of action' of private persons prevents private law from adopting the concepts of regulatory duty as one of its standards in other groups of consumers.

[1835] Mattew C. Stephenson, 'Public regulation of private enforcement: The case for expanding the role of administrative agencies' [2005] *Virginia Law Review* 93, 121-123

[1836] FSMA 138D (6)

[1837] [2012] CSOH 133 [79], where the court stated that "More widely, I don't think that GEL [Grant Estates Ltd.] can rely on the COBS rules to create a common law duty of care in relation to the provision of advice. *A common law duty can arise from the existence of a statutory duty as part of the background circumstances; and the existence of a statutory duty may show that a particular risk should have been foreseen.* When the court assesses the effect of the statutory duty on the question whether it is just and equitable to impose a duty of care the primary consideration is, in my view, the policy of the statute. Looking to the policy of the FSMA one discovers that it provides protection to consumers of financial services through a self-contained regulatory code and statutory remedies for breach of its rules. As I have said, it needs no fortification by the parallel creation of common law duties and remedies. Further, *the existence of a duty in negligence for failure to comply with the COBS rules would circumvent the statutory restriction on the direct right of action* which I discussed… To my mind that approach is applicable also where Parliament imposes statutory duties on private bodies and individuals." [emphasis added]

[1838] The Financial Services Act 1986 (Restriction of Right of Action) Regulations 1991, SI 1991 No 486, para 2.1

[1839] Ibid para 2.1

(1) Expanding the ambit of s138D of FSMA

Expansion of entitlement of the 'right of action' in Section 138D is key to complete harmonization of private law and regulation. For over two decades since the promulgation of Section 62A (later s150 and s138D), eligible persons have hardly used the 'right of action'.[1840] This is because it was granted to a small group of consumers, who are least likely to bring claims to court. Section 138D entitles 'private persons', usually with limited resources for litigation, to 'right of action'.[1841] In addition, because individuals can get compensation through the FOS without litigation, the 'right of action' isn't significantly meaningful if their reward isn't beyond the limit of the FOS.

On the other hand, companies that are relatively better resourced for litigation and are excluded from the protection of the FOS[1842] cannot avail themselves of the 'right of action' for breach of regulatory duty. The recent IRHPs scandals highlighted this limitation of section 138D: SMEs and micro-businesses—which were excluded from regulatory compensation including FOS rewards and hence pursued lawsuits for IRHPs-related losses—couldn't use section 138D's 'right of action' in court, but had to depend on private law principles such as misrepresentation.[1843]

At the time of promulgation of Section 62A, many commentators opposed the restriction.[1844] The rationale for restricted entitlement to the statutory 'right of action' is no longer persuasive. It is argued that concerns about the risk of vexatious lawsuits were unfounded, since conferring on the 'right of action' from regulatory breach would not increase the risk of excessive litigation. This is because breach of statutory rules always 'had the possibilities to raise a "right of action"' in private law, as the Department of

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[1840] Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (1994) 15 (6*) Comp.Law.* 172, n2; Financial Services Authority, 'Conduct of Business Sourcebook: Feedback on consultation and 'final text' and consultation on supplementary rules' (FSA, 2001) para 3.47

[1841] Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (1992) 13 (11) *Comp.Law.* 210; Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (n1840)

[1842] See n980

[1843] See Table 3 at p251

[1844] Joanna Gray, 'Financial Services Act 1986 reforms: Part2' (1991) 9 (9) *Int.Bank.L*. 412; Eva Z. Lomnicka, 'Curtailing section 62 actionability' [1991] *J.B.L.* 353; Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (n1840); Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (n1841)

Trade and Industry acknowledged.[1845] This implies that anybody without the statutory 'right of action' could still bring 'vexatious' lawsuits to court.

Cases where 'private persons' (or 'private investors') used the 'right of action' are very rare[1846] and limited to very wealthy individuals. In the area of over-the-counter derivatives, only 3 out of 15 consumers,[1847] whose investment size was beyond dozens of millions of pounds, used the 'right of action' as private persons.[1848] This empirically indicates that the range of the 'right of action' is too narrow to be employed.

It was especially disproportionate to exclude all kinds of companies from the statutory 'right of action' merely to prevent strategic lawsuits by competitors in the financial services sector.[1849] Further, the concerns[1850] voiced at the time of an overly descriptive rulebook are no longer relevant because rulebooks are made at EU level under 'maximum harmonization'[1851] or the single rulebook model.[1852]

There appears to be no definite reasons for the hesitation to entitle all consumers to the 'right of action' from contravention of regulatory rules. It is sufficient to exclude financial institutions from the 'right of action' to prevent 'strategic'[1853] lawsuits between competitors in the financial services industry. This modification doesn't require consent of parliament, because government has been delegated the power of defining the 'private person' who has the 'right of action'.[1854] Swift modification of the ambit of a

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[1845] Department of Trade and Industry, *Defining the private investor: a consultative document (*n1385) 3

[1846] Iain G. Macneil, 'FSA 1986: does s.62 provide an effective remedy for breaches of Conduct of Business Rules?' (n1840) n2

[1847] See Table 2 at p 188

[1848] *Morgan Stanley UK Group v Puglisi Cosentino* [1998] C.L.C. 481; *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM); [2012] EWCA Civ 583; *Basma Al Sulaiman v Credit Suisse Securities* (Europe) *Limited, Plurimi Capital LLP* [2013] EWHC 400 (Comm)

[1849] Julian Pritchard, 'Investor protection sacrificed: the new settlement and s.62: part2' (n1841)

[1850] See n1833

[1851] Niamh Moloney, *EU Securities and Financial Markets Regulation* (Oxford University Press 2014) n167; Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) 14

[1852] This argument depends on the future agreements between the UK and EU on how to harmonize the financial regulation in two jurisdictions after the Brexit.

[1853] See n1832

[1854] FSMA 2000, s 138D (6)

'right of action' in line with the change of the financial environment follows the purpose for which the statute delegated such power.[1855]

As an added point, the COBS, created after a long period of consultation and research,[1856] already categorized consumers into three groups, and differentiated the applicability of its rules for each group.[1857] Therefore, the FSMA 2000 doesn't need to define another consumer classification, a 'private person', different from the one of the COBS. The Department of Trade and Industry acknowledged [1858] that this creates 'unnecessary variations' in client classifications. Expanding the ambit of the 'right of action' to all consumer types except financial institutions could remove the confusion in financial law's consumer categorization, and promote complementary interplay between private law and statutory regulation.

6.3.1.2 Relaxed causation test

Section 138D of the FSMA 2000 stipulates that a private person has a 'right of action' when she suffers loss 'as a result of' contravention of regulatory rules.[1859] The phrase 'as a result' requires the claimant to prove causality between financial institutions' breach of regulatory rules and her loss.[1860] The court confirmed that the ordinary causation test in common law, which requires the claimant to prove that his loss would not have occurred 'but for' the breach (factual causation) and that his loss was not 'remote' from the breach (legal causation),[1861] should be applied in interpreting the phrase 'as a result'.[1862]

[1855] Secretary of State of the DTI , 'HL Deb 16 Jan vol 503 c17', <http://hansard.millbanksystems.com/lords/1989/jan/16/companies-bill-hl> accessed 20 June 2016; See Mattew C. Stephenson (n 1835) 121-139

[1856] Hugh Collins, 'The hybrid quality of European private law' in Tatjana, Josipović, et al, *Foundations of European Private Law* (Hart Publishing 2011) 457

[1857] FCA Handbook, COBS 3.4, 3.5, 3.6; Directive of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC, Article 4

[1858] Department of Trade and Industry, *Defining the private investor: a consultative document (*n1385) 8

[1859] FSMA 2000, s138D

[1860] Sandy Steel (n 1402) 1; Kirsty Horsey and Erika Rackley *Tort Law* (Oxford 2013) 222

[1861] Gerard McMeel and John Virgo (n 1354) para 23.177 and 23.188

[1862] *Adrian Rubenstein v HSBC* [2012] EWCA Civ 1184; George Walker, Robert Purves and Michael Blair (n 439) para 7-30

However, it is difficult for consumers to prove causation in private law. For factual causation, the consumer should prove that he would have acted differently if the financial institution had not contravened regulatory rules.[1863] For instance, for the ordinary causation test, a consumer should show that he would not have entered into the over-the-counter derivatives contracts if the financial institution had provided suitable advice or fair communication. This is quite difficult for consumers since financial institutions' representatives orally deliver much of the advice and information regarding investment, and since there is lack of hard evidence.[1864] Further, behavioural science shows that consumers cannot explain particular behaviour, due to the many factors affecting their behaviour.[1865]

Concerning causation, the affected consumer should establish that the regulatory breach by the financial institution is the 'real' cause of his detriment, among many possible causes.[1866] The cases of 'mis-selling' of over-the-counter derivatives usually indicate that unexpected market turmoil reveals regulatory breach such as unsuitable advice or unfair communication.[1867] Without market turmoil, the consumer's detriment might not have occurred and the regulatory breach might not have been known by anybody, including the consumer. Even the judge finds it difficult to select the real cause of consumer detriment between market turmoil and regulatory breach.[1868] The burden of proof is on the claimant; however, the multiplicity of possible causes makes proof of causation more difficult for consumers.[1869]

Pursuing 'precise' causation may be similar to chasing a mirage because, as Laleng contended, the conclusion of causation must be intrinsically 'interpretative' and

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[1863] Norbert Reich, 'The interrelationship between rights and duties in EU law' [2010] *Yearbook of European Law* 112, 158; Olha O. Cherednychenko 'Financial Consumer Protection in the EU: Towards a Self-Sufficient European Contract Law for Consumer Financial Services?' (n 1738) 492

[1864] Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge University Press, 2010) 292

[1865] Rossella Incardona and Cristina Poncibo, 'The average consumer, the unfair commercial practices directive, and the cognitive revolution' (n404) 21; The Law Commission and the Scottish Law Commission (n 1350) 137

[1866] See n1405

[1867] See 5.1.1.6

[1868] See n1414

[1869] Ibid

'probabilistic'.[1870] He therefore argued that 'there is no such thing as objective causation in law'.[1871] Practically, the FSA pointed out that the strict causation clause test of general law constrained its capability to compensate consumers.[1872] The empirical research of Porta and others also showed that the burden of proof of causation on consumers in civil law had a strong negative correlation with the development of the capital market.[1873]

For these reasons, some commentators contend that the burden of proof of causation in the financial services sector should shift to the defendant once the claimant proves the defendant's regulatory contravention.[1874] However, caution is necessary in reversing the burden of proof of causation to the defendant, because it isn't consistent with the 'compensatory aim of private rights'.[1875]

The 'Consumer Protection (Amendment) Regulations 2014' (CPR 2014)[1876] provides a good model for modification of the strict causation test when a 'right of action' for regulatory breach brings a case to court. CPR 2014 confers a 'right of action'[1877] from regulatory breach on consumers, and requires them to prove that the breach is 'a significant factor'[1878] for their purchase of products or services. It statutorily relaxes the causation test from the 'but for' to the 'significance' test. The Law Commission recommended the relaxed causation test in its 2012 report 'Consumer Redress for Misleading and Aggressive Practices'.[1879] It concluded that it was unrealistic to require consumers to prove that they would not have entered into the contracts 'but for' the

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[1870] P Laleng (n 1512) n5; see also Donal Nolan, 'Causation and the goals of tort law' (n1513) 167; The Law Commission and the Scottish Law Commission (n 1350) para 8.4-8.5

[1871] P Laleng (n 1512) n5

[1872] Financial Services Authority, 'Written evidence in Joint Committee on the Draft Financial Services Bill Evidence' (2011) 583 <http://www.parliament.uk/documents/joint-committees/Draft-Financial-Services-Bill/WEBWRITTENEVIDENCE.pdf> accessed 2 July 2016

[1873] Rafael Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'What works in securities laws?' (2006) 61.1 *The Journal of Finance* 1, 19

[1874] See eg Norbert Reich (n 1863) 158

[1875] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (LAW COM No 332, SCOT LAW COM No226, 2012) para 7.108; See also Sandy Steel (n 1402) 121-136

[1876] The Consumer Protection (Amendment) Regulations 2014, 2014 No.870

[1877] Ibid s27A. (1)

[1878] Ibid s27A. (6) which stipulates 'The third condition is that the prohibited practice is a significant factor in the consumer's decision to enter into the contract or make the payment.'

[1879] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (n 1875) para 7.116

sellers' breach;[1880] however, it objected simultaneously to reversing burden of proof for causation to sellers, because this was against fair allocation of duties and rights.[1881] As a solution, it suggested the 'significance' test, which required consumers to prove that the sellers' breach affected their purchase decision 'significantly'.[1882]

However, the Law Commission excluded the financial services sector from the ambit of CPR 2014, explaining that it already had sophisticated regulation and the FOS's generous compensation system.[1883] While the explanation pertaining to the elaborate regulatory system is correct, it cannot be the rationale for subjecting the financial services sector to a different causation test than the other consumer industries. Section 5.3.1 demonstrated that the financial services sector[1884] has the same problem of insufficient regulatory enforcement as identified by the Commission for other consumer industries.[1885] The FOS's protection is also limited in terms of the subject and reward amount, and a substantial number of consumers, especially SMEs, should thus rely only on private law for compensation.[1886] Therefore, there seems to be no coherent reasons to treat the financial services industry different from other consumer industries in terms of the causation test.

Some may express concerns that the eased causation test in the financial services sector, where unexpected market movements incur losses to consumers, will entice them to bring meritless litigation for compensation. However, it should be remembered that the burden of proof of regulatory breach is still on the consumer, and evidencing the regulatory breach of financial institutions during pre-contractual communication—usually done orally—isn't easy for consumers. *Zaki & others v Credit Suisse (UK) Limited*[1887] illustrates the difficulty for a consumer to establish regulatory breach by financial

[1880] Ibid para 7.108
[1881] Ibid
[1882] Ibid para 7.116
[1883] Ibid para 6.107-118
[1884] See p268 and p268
[1885] The Law Commission and the Scottish Law Commission, *Consumer Redress for Misleading and Aggressive Practice* (n 1875) para 1.7
[1886] See n1690, n1691 and n1692
[1887] *Zaki & others v Credit Suisse (UK) Limited* [2011] EWHC 2422 (COMM)

institutions. The claimant made considerable forensic efforts to demonstrate the financial institution's regulatory breach during the sales process, which was possible due to his affluence;[1888] however, even in his case, the court rejected most of his claims about regulatory breach—such as provision of unsuitable advice[1889]. Considering the difficulty of evidencing a financial institution's regulatory breach in court, it appears an unreasonable concern that relaxation of the causation test will increase meritless consumer litigation.

In summary, a relaxed causation test is required to better enable the complementary role of private enforcement of regulation. For consistent implementation, the relaxed causation test of 'significance' should be clearly expressed by amending section 138D of FSMA 2000.

6.3.2 South Korea

South Korea, which traditionally has a command-and-control regulatory culture, suffers from the transplant effects[1890] of adopting the COB with its vague and purposive requirements, such as suitability and fair communication. The South Korean rule-maker completely delegated the implementation of the suitability rule and the 'duty to explain', which are difficult to specify and monitor compliance, onto the regulated.[1891] Such a full delegation removed the opportunity for conversation between the regulator and the regulated community, through which a common understanding of the vague and purposive requirements should have been developed. Consequently, the regulator and the regulated are both failing to harness the capability to apply the COB to many different circumstances.

Full delegation is also a form of the command-and-control regulatory culture. This is based on the idea that actors in the regulatory space have separate roles: the rule-maker develops regulation, the regulated follow the regulation, and the enforcer detects and

[1888] Ibid [2], [103]

[1889] See p 2 4 4

[1890] See p 2 1 3

[1891] See p 1 1 5

penalises contravention. Command-and-control style regulation is effective when the regulator has perfect market information.[1892] However, in the financial services industry, the regulated, if they well understand what the intended regulatory outcomes are, know much better than the regulator how to achieve them.

The South Korean regulator must strengthen the conversation with the regulated community about the intended outcome of the COB, thus enabling the regulated's practical experience and knowledge to be used in the regulatory process. Conversation should be a device by which the regulator and the regulated obtain a shared understanding about the regulatory outcome, rather than a device for the regulator's one-sided communication.

The regulator must avoid overly rigid application of the principles of clarity and of pre-formulation of state actions by legislation.[1893] As the constitutional court stated, a certain level of vagueness in rules and delegation of rule-making to the regulator cannot be avoided when the regulated subject is complex.[1894] When considering the fast speed of change in the financial market, strict application of the principle of pre-formulation of state actions by legislation and the principle of clarity seriously damages the responsiveness of regulation.

Enforcement in South Korea must focus on outcomes rather than on executing sanctions; a focus on sanctioning procedural breach results in the regulated also focusing on compliance with procedure rather than on regulatory outcome. In South Korea, sanctions focused on procedural breach have produced much regulatory unreasonableness, and created hostility to, and blind compliance with, regulation.

[1892] For general comment of strength of command and control regulation, see Robert Baldwin, 'Regulation after 'command and control' (n762) 66

[1893] See John K.M. Ohnesorge, 'Asia's Legal Systems in the Wake of the Financial Crisis: Can the Rule of Law Carry any of the Weight?' in Meredith Jung-En Woo, *Neoliberalism and Institutional Reform in East Asia* (Palgrave Macmillan, 2007) 63, 82-83

[1894] See p 1 0 2

The reform recommended above ultimately raises the issue of the regulator's accountability.[1895] This refers to regulator's obligation to account for regulatory activities to another person.[1896] An accountability concern in the regulatory process is the challenge of the 'democratic quality' of regulation,[1897] and is also related with the question of "rules or discretion" discussed in chapter I.[1898] Rules and discretion are not alternatives that could replace each other, but complements that could compensate for what the other lacks.[1899] A regulatory system that excessively relies on rules rather than discretion induces ineffectiveness and unreasonableness due to the inherent limitations of rules.

The South Korean command-and-control style regulation regime demands compliance-accountability of the regulator, in which it is subject to detailed and precise rules.[1900] The Supreme Prosecutors' Office's prosecution and the National Board of Audit and Inspection's penalty against individual officers of the South Korean regulator are for the alleged failure to comply with precise and detailed rules.[1901] These rules are stipulated mainly in the primary legislation, and the South Korean compliance-accountability mechanism requires accountability of the regulator to parliament through compliance with the rules rectified by parliament. This is a strict form of 'representative democratic oversight'.[1902] Braithwaite called pursuing simple accountability regulatory 'ritualism'.[1903]

[1895] Karen Yeung, *Securing Compliance: A Principled Approach (*Hart Publishing, 2004); see also Martin Lodge, 'Accountability and Transparency in Regulation' (n1798) 124, where the author argued that the rise of regulatory state inevitably led to the debate concerning accountability of the regulator; see also Richard Rawlings 'Introduction: Testing Times' (n1052) 1-2; Cosmo Graham, 'Is there a crisis in regulatory accountability' (n909) 482-485; Francesca Bignami, 'Introduction: A new field: comparative law and regulation' in Francesca Bignami and David Zaring, *Comparative Law and Regulation (*Elgar, 2016) 12-13, where the author explained that the demand of accountability on regulatory regime is based on the logic of liberal democracy.

[1896] Martin Lodge, 'Accountability and Transparency in Regulation' (n1798) 127; see also Collin Scott (n1896) 40

[1897] David Levi-Faur, 'Regulation and Regulatory Governance' in David Levi-Faur, *Handbook of Politics of Regulation* (Edward Elgar Publishing, 2013) 15-16

[1898] See section 1.3.2

[1899] Cosmo Graham, 'Is there a crisis in regulatory accountability' (n909) 510

[1900] Christopher Hood, et al, *Regulation inside government: Waste watchers, quality police, and sleaze-busters* (n894) 6

[1901] See p 1 9 9

[1902] Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' (n547) 243

An accountability mechanism that focuses on the regulator's compliance with rules aims to control its use of discretion. However, in the regulatory process, it is impossible to remove the room for regulatory discretion entirely.[1904] For example, even with extremely detailed and precise rules, the enforcer can choose whether or not to 'detect' a breach that has been found.[1905] If only the regulator's rule-based accountability is emphasised, there will be covert or unofficial use of discretion, which is inevitable in the regulatory process. South Korea uses an audit by The National Board of Audit and Inspection to secure this narrowly defined accountability of the regulator. However, Power warned of the tragic consequence of 'audit', which might jeopardise the existing accountability mechanism and result in failure of the system to achieve its regulatory goal.[1906]

Adherence to a rigid and rule-based regulatory system doesn't necessarily increase accountability, but demands a sacrifice of the rationality of the regulatory regime.[1907] An extremely formal mechanism for securing the regulator's accountability might reveal the legislature's weak capability to monitor and review the regulator's activities.[1908]

Many jurisdictions with highly developed financial markets have moved away from adherence to rigid legalism.[1909] In the US, which used to have a rather adversarial and legalistic regulatory regime, the non-delegation doctrine doesn't act as a constraint in

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[1903] John Braithwaite, *Regulatory Capitalism: How It Works, Ideas for Making It Work Better* (Edward Elgar Publishing, 2008) 142

[1904] Malcom K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance (*Brooking Institution Press, 2011) location 457-475

[1905] Ibid

[1906] See Michael Power, *The Audit Society* (Oxford, 1997) 97-119; see also Colin Scott, 'Accountability in the regulatory state' (2000) 27.1 *Journal of law and society* 38, 50-52; see also Robert Baldwin and M. Cave, *Understanding Regulation: Theory, Strategy and Practice* (n8) 349;

[1907] Cosmo Graham, 'Is there a crisis in regulatory accountability' (n909) 502 and 510; see also Tony Prosser, 'Conclusion: Ten Lessons' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications* (Oxford University Press, 2010) 312

[1908] John K.M. Ohnesorge, 'The Regulatory State in East Asia' in Francesca Bignami and David Zaring, *Comparative Law and Regulation (*Elgar, 2016)

[1909] See Giandomenico Majone, 'Theories of Regulation' in Pio Baake et al. *Regulating europe* (Psychology Press, 1996) 39-43; see also David Levi-Faur, 'The Global Diffusion of Regulatory Capitalism' available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=958100 15-16, where the author explained that the states retains responsibility for steering, while business increasingly takes over the functions of service provision, in the global spread of regulatory capitalism; see also John Braithwaite, *Regulatory Capitalism: How It Works, Ideas for Making It Work Better* (Edward Elgar Publishing, 2008) 26, where the author argued that 'the idea of a separation of powers where one branch of governance regulate another…is an old one..'

the independent regulator's rule-making.[1910] In Germany, whose civil law system significantly influenced the South Korean Constitution,[1911] the Federal Constitution Court has permitted inclusive delegation in rule-making.[1912] In Japan, the regulatory agency launched the 'better regulation' initiative, of which the first pillar was the 'optimal combination of rule-based and principle-based supervisory approach'.[1913]

Securing the regulator's accountability through rule compliance is a very crude mechanism,[1914] because it causes much unreasonableness and ineffectiveness in the regulatory regime, as seen in chapter IV. The regulator's accountability should not only be restricted to parliament, considering the complexity and speedy change in the financial markets, and politicians' lack of expertise and time.[1915] The regulator's accountability isn't only to parliament but also to the regulated,[1916] and not only by the regulator's compliance with rules but also its performance.[1917] Susan argued that:

[1910] Susan Rose-Ackerman, 'The Regulatory State' (n817) location 16176; see also Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' (n547) 249, which explained that the US has also developed its peculiar delegation system of rule-making, which allows independent regulatory agency to make regulatory rules but not allow the president and its administration; see also See Marver H. Bernstein, *Regulating business by independent commission* (Princeton University Press, 2015) 151, where the author explained that Congress conceives of independent regulatory commission as agents of congress rather than of the executive.

[1911] Simeon Djankov, Caralee McLiesh and Andrei Shleifer, 'Private Credit in 129 Countries' (2005) Appendix A, available at <http://www.nber.org/papers/w11078> accessed 9th August 2017; see also John K.M. Ohnesorge, 'The Regulatory State in East Asia' (n1908) 92

[1912] Susan Rose-Ackerman, 'The Regulatory State' (n817) location 16176; for detailed comparative study of financial services regulation, see Marvin Fechner and Travis Tipton, 'Securities Regulation in Germany and the US' (2016) *Comparative Corporate Governance and Financial Regulation* 41-44 available at <http://scholarship.law.upenn.edu/fisch_2016/5> accessed 22nd July 2017

[1913] Mamiko Yokoi- Arai and Tetsuo Morishita, 'Evolving supervisory and regulatory approaches of Japan in the post-crisis era' in Robin Hui Huang and Dirk Schoenmaker, *Institutional Structure of Financial Regulation: Theories and International Experiences* (Routledge Research in Finance and Banking Law, 2014) 175-176

[1914] Julia Black, 'Using rules effectively' (n678) 112; see also Roberto RC Pires, 'Beyond the fear of discretion: Flexibility, performance, and accountability in the management of regulatory bureaucracies' (2011) 5.1 *Regulation & Governance* 43, 62-63

[1915] See Cosmo Graham, 'Is there a crisis in regulatory accountability' (n909); see also Robert Baldwin and M. Cave, *Understanding Regulation: Theory, Strategy and Practice* (n8) 288; see also Susan Rose-Ackerman, 'The Regulatory State' (n817) location 16474-16492; see also See Marver H. Bernstein, *Regulating business by independent commission* (Princeton University Press, 2015) 262, where the author argued that the reluctance of politicians to be involved in resolving interest conflicts of different social groups is another limitation of the parliament's role in regulatory process.

[1916] Julia Black, 'Using rules effectively' (n678) 112; see also Paul Graig, *Administrative Law (*Sweet & Maxwell, 2016) location 19069

[1917] Christopher Hood, et al, *Regulation inside government: Waste watchers, quality police, and sleaze-busters* (n894) 6

'A rigid separation of powers – where the legislature is the only source of legal norms, the government bureaucracy implements the law, and the judiciary oversees compliance with the law – cannot withstand the pressures of modern policymaking realities'.[1918]

In the UK, the regulator is given very inclusive rule-making power, with rules that are also vague and purposive. In terms of compliance-accountability, the UK regulator's accountability is very low. However, there is a hybrid accountability mechanism by consultation process, cost-benefit analysis in rule-making, and transparent publication and judicial review of its enforcement.[1919] Most importantly, there are checks and balances in the constituents in the regulatory space.[1920] Hood argued that the most effective remedy for negative bureaucratic behaviour is more likely to be 'political actions' rather than 'legal rules'.[1921]

The South Korean regulator needs a hybrid accountability mechanism. Scott argued that a concept of 'extended accountability' should be conceived, of which accountability to parliament should be just one part.[1922]

In extended accountability, the regulator should be accountable to parliament as well as the regulated community; the accountability should not only be about compliance with rules, but also about its performance in achieving regulatory goals. Ultimately, the regulator should be accountable to the general public, who can only be represented by

[1918] Susan Rose-Ackerman, 'The Regulatory State' (n817) location 16176

[1919] Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' (n547) 244; the regulator of the UK publicised its disciplinary actions by 'final notice' even though the voluntary redress regime has had quite non-transparency; see also Jody Freeman, 'The Private Role in Public Governance' (n1278); see also Tony Prosser, 'Conclusion: Ten Lessons' in Dawn Oliver, Tony Prosser, and Richard Rawlings (eds), *The regulatory state: constitutional implications* (Oxford University Press, 2010) 317; Susan Rose 'The regulatory state' 16326-16474

[1920] See p 2 2 2

[1921] Christopher Hood, *The blame game: Spin, bureaucracy, and self-preservation in government* (Princeton University Press, 2010) 178

[1922] Collin Scott (n1896) 48; see also John Braithwaite, *Regulatory Capitalism: How It Works, Ideas for Making It Work Better* (Edward Elgar Publishing, 2008) 33, where the author argued that 'innovative separations of powers can deter abuse of power.

agents.[1923] However, not only elected politicians should be considered as agents of the general public in the regulatory process.[1924] As the regulated community is the group that can best assess the cost-benefit of regulation, it can be rationalised that the regulator is accountable to the regulated community.[1925] Of course, care should be taken to ensure that this accountability doesn't lead to regulatory capture.[1926] Under extended accountability, the regulator and the regulated have interdependence of accountability in the financial services regulatory space.[1927]

Cooper et al. argued that measuring the welfare effects of a policy assist in correcting the regulator's myopia.[1928] However, objective assessment of regulatory performance is extremely challenging due to complex regulatory objectives and various audiences.[1929] The regulatory goal can vary by actor in the regulatory space, and there can be trade-offs between different values; politicians can stress the transparency and accountability of regulatory actions; and financial institutions may emphasize the efficiency of regulatory process and its competitiveness in the international market.[1930] Considering the various perspectives and interests of different constituents in the regulatory space, regulatory goal setting in itself needs to be a political process.[1931] Therefore, the assessment of

[1923] See Marissa Martino Golden, 'Interest Groups in the Rule-Making Process: Who Participates? Whose Voices Get Heard?' (1998) 8.2 *Journal of Public Administration Research and Theory* 245, 265 where the author showed the virtual absence of actual citizen participation in rule-making in the US.

[1924] See Giadomenico Majone 'Regulatory Legitimacy' in Bronwen Morgan and Karen Yeung, *An introduction to law and regulation: text and materials* (Cambridge University Press, 2007) 254-260

[1925] See Julia Black, 'Using rules effectively' (n678) 111-112; see also Dawn Oliver, 'Regulation, democracy, and democratic oversight in the UK' (n547) 243

[1926] See Dawn Oliver (n1925) 249

[1927] Colin Scott, 'Accountability in the regulatory state' (n1906) 50-52

[1928] James C. Cooper and William E. Kovacic, 'Behavioral economics: implications for regulatory behavior' (n1243) 54-55

[1929] Robert Baldwin, 'Better Regulation: The Search and The Struggle' in Robert Baldwin, Martin Cave, and Martin Lodge, *The Oxford handbook of regulation* (Oxford University Press, 2010) 269-271

[1930] See Claudio M. Radaelli and Fabrizio De Francesco, *Regulatory Quality in Europe (*Manchester University Press, 2013) location 920-1133 (kindle edition)

[1931] See Marver H. Bernstein, *Regulating business by independent commission* (Princeton University Press, 2015) 154-161, where the author argued that even independent regulatory agency cannot decide by itself which policy option is for public interest because its legislative mandate is a very general guide for its policy choice and its experience is narrow.

regulatory performance must also be collectively conducted by networked constituents in the regulatory space.[1932]

[1932] Robert Baldwin, 'Better Regulation: The Search and The Struggle' in (n1929) 271-274; see also Claudio M. Radaelli and Fabrizio De Francesco, *Regulatory Quality in Europe (*Manchester University Press, 2013) location 3752- 377; See also Ross Levine, 'The governance of financial regulation: reform lessons from the recent crisis' (2010) 12.1 *International Review of Finance,* where the author proposed a new institution which would assess the effectiveness of financial regulation; see also Alberto Alemmano et al*, Better Business Regulation in A Risk Society (*Springer, 2012) location 2978-3004, where the authors argued that assessing regulatory success 'must obviously always remain a political decision, but that political decision should at least be based on a full overview of facts.'

6.4 Contribution of the thesis

The contribution of this thesis lies in its application of existing theories about rule-making and rule-enforcing in current literature to the COB regimes of South Korea and the UK to explain the causes of regulatory failures in the two countries. Through this process, the thesis has tested and validated the theoretical models in the context of a research site of huge significance in many jurisdictions. In terms of rule-making, the under-inclusiveness issue of specific and precise rules as maintained by Pistor and Xu is identified as a real problem in South Korea, and Armour's argument that regulators are incentivised more towards avoiding prominent failures than achieving regulatory success is demonstrated in South Korea where the regulator addresses under-inclusiveness by applying zero-tolerance rule-making and completely prohibiting certain transactions. In the UK, it is shown that using various rule-types such as purposive principles (Principles and Rules) with binding effect as well as specific rules (Guidances) that are non-binding and provided for information purposes help to improve the effectiveness of the regulatory regime as explained by Black. Bardach's theory is validated in South Korea where enforcement and compliance focus too much on the letters of rule and lead to the problem of legalistic enforcement that is distant from the regulatory objective. The thesis also shows how the UK fell into Parker's compliance trap as a result of its compliance-oriented and reactive enforcement where ill-intended regulatees were not considered.

Secondly, the thesis presents proposals for reform that addresses the causes of the regulatory failures in the two countries. With respect to the UK, the biggest cause of regulatory failure is identified as the dissonance of standards between COB and private law and so a proposal for specific revisions to the legislation for harmonized interplay between the two institutions is presented. With respect to South Korea, it is proposed that the command-and-control regulatory culture be changed to decentred regulation based on partnership. The proposals for reform as presented in the thesis are those that have never been made before. Especially in South Korea, where the discussions by academia about COB are focused on criticizing the adjudications made by the court, I hope that discussion of this thesis about the effectiveness of COB regime will serve as a

catalyst for further academic research across a range of disparate jurisdictions all facing the same essential problems posed by global finance but having evolved very different regulatory and legal responses that are of varying levels of effectiveness.

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