

**An Evaluation of Investor Protection in Secondary Securities
Markets**

*A Comparative Study of Regulatory Regimes in the United Kingdom and Saudi
Arabia*

A thesis submitted for the degree of Doctor of Philosophy

By

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ABSTRACT

This thesis discusses differences in countries' approaches to investor protection regulation and explores the reasons why they exist in the first place as well as why they are likely to persist. I first provide a framework that can explain the need for regulation in financial markets in general and secondary capital markets in particular. Next, taking the United Kingdom and Saudi Arabia as case studies, I present descriptive and stylised evidence on regulatory and institutional differences across countries with regards to private enforcement of regulatory duties. Differences in the institutional treatment of those entitled to the regulatory protection as well as what regulatory duties entail are evident. However, the two countries are similar in that they both provide for private enforcement of regulatory duties through a cause of action in tort. An important implication of this finding is that the level of protection provided is unlikely to converge globally, despite efforts to harmonies by the International Organization of Securities Commissions (IOSCO). Convergence of the legal protection provided for investors is also unlikely due to persistent differences in tort law around the world. Given an ostensibly strong need for appropriate level of protection for investors, I propose a different way forward that does not require convergence of substantive regulation and enforcement across countries.

LIST OF RULES, STATUTES, REGULATIONS AND OFFICIAL DOCUMENTS IN BOTH THE UK AND SAUDI ARABIA

The UK

Acts

- The Companies Act 1989
- The Financial Services Act 1986
- The Financial Services and Markets Act 2000
- The Parliamentary Commissioner Act 1967
- The Unfair Contract Terms Act 1977

European Directives

- The Markets in Financial Instruments Directive, 2004/39/EC

Secondary Legislations

- The Civil Procedure Rules 1998 (SI 1998/3132)
- The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)
- The Financial Services and Markets Act 2000 (Rights of Action) Regulations (SI 2001/2256)

Regulations

- The FSA, Conduct of Business Rulebook, Effective until 2007

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Official Documents

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Saudi Arabia

Acts

- The Banking Control Law, “*Qanoon Moraqabat Albonok*” issued by Royal Decree No. M/5 dated 22/02/1386 H. (1966)
- The Basic Law of Saudi Arabia, “*Alnizam Alasasi Lil Hokm*” issued by Royal Decree No. A/90 dated 27/08/1412 H. (1992)
- The Capital Market Law, “*Nizam Alsooq Almalyah*” issued by Royal Decree No. M/30 dated 2/6/1424H. (2004)
- The Charter of the Saudi Arabian Monetary Agency “SAMA”, “*Nizam Mossasat Alnaqd Alarabi Alsaudi*” issued by Royal Decree No. 23 dated 23/05/1377 H. (1957)

- The Code of Commercial Court, “*Nizam Almahkamah Altijaiyah*” issued by Royal Decree No.32 dated 15/01/1350 H. (1931)
- The Company Law, “*Nizam Alsharikat*” issued by Royal Decree No. M/6 dated 22/03/1385 H. (1965)
- The Law of Commercial Papers, “*Nizam Alawraq Altejariyah*” issues by Royal Decree No. 37 dated 11/10/1383 H. (1963)

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- Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority
- The Authorised Persons Regulations of the Capital Market Law
- The Conduct of Market Regulations of the Capital Market Law
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- *R (on the application of Green trading as Green Denman & Co) v Financial Ombudsman Service Limited* [2003] EWHC 338 QBD (Admin)
- *Woods v. Martins Bank Ltd* [1959] 1 QB 55 (Ch. Div.)
- *Rust v. Abbey Life Insurance Co. Ltd* [1978] Lloyd's Rep 386
- *Re Whiteley Insurance Consultants (WIC)* [2008] All ER, [2008] EWHC 1782 (Ch)
- *Clairon Ltd v. National Provident Institution* [2000] 1 WLR 1888
- *R (on the application of the British Bankers Association) v Financial Services Authority and another* [2011] EWHC 999
- *Thornton v Kirklees Metropolitan Borough Council* [1979] QB 626

- *Building and Civil Engineering Holidays Scheme Management Ltd v Post Office* [1966] 1 QB 247
- *South Australia Asset Management Corporation v. York Management Ltd* [1997] AC 191; [1996] 3 All ER 365
- *Bunney v Burns Anderson Plc* [2007] EWHC 1240 (Ch)
- *Hall v Cable and Wireless Plc* [2009] EWHC 1793 (Comm)
- *Lonrho Ltd v Shell Petroleum Co Ltd (No.2)* [1982] AC 173
- *Nestle v. National Westminster Bank Plc* [1994] 1 All ER 118
- *Bank Leumi (UK) plc v Wachner* [2011] EWHC 656 (Comm)
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- *Aberdeen Railway Co v Blaikie Brothers* [1854] 1 Macq 461
- *Goldcorp Exchange Ltd (in receivership), Re sub nom Kensington v Unrepresented Non-allocated Claimants Neutral Treatment Indicated* [1995] 1 AC 74
- *Rothschild v. Brookman* (1831) 2 Dow. & Cl. 188
- *Bristol and West BS v. Mothew* [1998] Ch.1
- *Western Insurance Company of New York v. Culiffe* (1874) Ch.app525
- *Re Market Wizard Systems (UK) Ltd* [1998] 2 B.C.L.C. 282
- *Walker v Inter-Alliance Group Plc (In Administration)* [2007] EWHC 1858 (Ch)
- *Marti v. Britannia Life Ltd* [2000] Lloyd's Rep. P.N. 412

International Arbitral Awards

- *Saudi Arabia v Arabian American Oil Company (Aramco)* Award of 23 August 1958 (1963) 27 ILR 117

Saudi Arabia

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LIST OF ABBREVIATIONS

APR	Authorised Persons Regulations
BIS	Bank of International Settlement
CMA	The Capital Market Authority of Securities Markets
CML	The Capital Market Law of Saudi Arabia
CMR	Conduct of Market Regulations
COB	The FSA's Rulebook, Effective Until 2007
COBS	The FSA's Conduct of Business Sourcebook, Effective from 2007
COMP	The FSA's Compensation Sourcebook
CRSD	Committee for the Resolution of Securities Disputes
CSBD	Committee for the Settlement of Banking Disputes
CSNID	Committee for the Settlement of Negotiable Instruments Disputes
DISP	The FSA's Complaint Sourcebook
ESIS	Electronic Security Information System
FCA	The Financial Conduct Authority
FDR	The Financial Development Report
FINRA	The US Financial Industry Regulatory Authority
FOS	The Financial Ombudsmen Services
FS	The Financial Services Act 1986
FSA	The Financial Services Authority
FSMA	The Financial Services and Markets Act 2000
ICFR	International Centre for Financial Regulation

IMF	The International Monetary Fund
IOSCO	The International Organisation of Securities Regulations
ISDA	International Swap and Derivatives Association
LSE	The London Stock Exchange
MifID	The Markets in Financial Instruments Directive
NASD	The US National Association of Securities Dealers
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OFT	The Office of Fair Trading
Order	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
OTC	Over the Counter (Off-exchange trading of securities)
Principles	The FSA's Principles for Business
ROA	Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001
SAMA	Saudi Arabian Monetary Agency
SEC	U.S. Securities and Exchange Commission in the United State
SETS	Stock Exchange Electronic Trading
SFA	The Securities and Future Authority
SIB	The Securities and Investment Board
SRO	Self-Regulating Organisations
SSRC	Saudi Share Registration Company
Tribunal	The Financial Services and Markets Tribunal

WTO

The World Trade Organisation

Chapter One

Introduction

Part I Research Background

In a world of greatly increased financial mobility between countries, a national financial market requires strong securities laws and institutions in order to protect the property rights of investors and to sustain domestic and international confidence in the economy.¹ Certainly, particular jurisdictions will have securities law regimes that differ in the relative burden of information disclosure, regulation of financial intermediaries, surveillance of trading systems, enforcement of the rights of investors, and control of required capital balances as a percentage of total assets held by financial firms.²

However, the competitiveness of international financial capital markets, combined with the increased utilization of technological advances in communications, permit investors to locate their trading activities wherever they find to be most appealing. Empirical research concerning the attitudes of investors shows that, in their decisions, confidence in a particular jurisdiction is based on the provision of a degree of certainty in the existence of clear remedies, accessible and comprehensible measures for participants, and predictable outcomes of judicial decisions.³ Therefore, it is claimed that the failure to provide adequate protection for investors can damage

¹ See Ross Levine and Sara Zervos, 'Capital Control Liberalization and Stock Market Development' (1998) 26 *World Dev.* 1169, 1179-89; John Coffee, Jr., 'Privatization and Corporate Governance: The Lessons from Securities Market Failure' (1999) 25 *J. Corp. L.* 1

² See for a general discussion Roberta S. Karmel, 'The Case for a European Securities Commission', (1999) 38 *Colum. J. Trans. Law* 9, 43

³ Bernard Black, 'The Legal and Institutional Preconditions for Strong Securities Markets: The Non-triviality of Securities Law' in Organisation for Economic Co-operation and Development (OECD) *Corporate Governance in Asia: A Comparative Perspective* (OECD 2001); Gerard McMeel and John Virgo, *Financial Advice and Financial Product* (OUP 2001).

confidence in the operation of capital markets, which is one category of securities markets, and, subsequently, undermine economic growth.⁴ It is within this framework of understanding of the public interest in the law applied to securities markets that the current role of the state in such law can be understood.

Accordingly, the principal remit of this thesis is twofold: firstly, to analyse how Saudi Arabia, as a geopolitical entity, has put into effect the framework of understanding in the relationship between the state, the law and secondary securities markets; and, secondly, to evaluate whether or not the outcomes of the implementation process can be explained by theoretical and empirical research.

Saudi Arabia is a developing country shifting towards new economic policies and moving towards a market economy model. The government's commitment in this respect is reflected in the adoption of market-oriented policies which resulted in Saudi Arabia's membership of the World Trade Organization (henceforth WTO) in December 2005.⁵ In the process of preparing for membership, Saudi Arabia enacted 42 new trade-related laws, created nine new regulatory bodies, and signed 38 bilateral trade agreements.⁶ As a result of these legal reforms, current investment and securities business activities (such as the provision of advisory services, asset management services, brokerage services, custodial services and the offer of securities by public offer or private placement) are now governed by the Capital Market Law (henceforth CML), which was enacted by Royal Decree M/30 on 1 August 2003. A new regulatory agency was established (the Capital Market Authority (henceforth CMA) and was given regulatory power to supervise and regulate securities markets.

⁴ Iain MacNeil, *An Introduction to the Law on Financial Investment* (Hart Publishing 2005) 290

⁵ WTO, 'Accession Saudi Arabia' <http://www.wto.org/english/thewto_e/acc_e/a1_arabie_saoudite_e.htm> accessed 29 June 2011

⁶ Samba Financial Group, 'Saudi Arabia and the WTO' (2006), <<http://www.susris.com/articles/2006/loi/060318-samba-wto.html>> accessed 29 June 2011

However, only limited research concerning the effectiveness of the enacted law and the regulatory regime introduced in Saudi Arabia has been conducted,⁷ and no previous Saudi study has dealt in detail with regulatory duties in secondary securities markets. Consequently, it is intended that this research will be of benefit in three ways. Firstly, it will fill a gap in the literature concerned with securities markets in Saudi Arabia; secondly, it will provide an understanding of the legal context and challenges facing securities markets in Saudi Arabia; and finally, it will make available to policymakers and the draftsmen of future legislation on securities markets in Saudi Arabia recommendations about certain measures for development.

To achieve the aims of this research, it is deemed appropriate to conduct a comparison of the Saudi legal system for securities markets with one that is well-established and recognised to be a leading and sophisticated legal system, such as the United Kingdom. Accordingly, this research analyses the legislation concerning securities markets in the United Kingdom, namely the Financial Services and Markets Act 2000 (henceforth FSMA). However, given that Saudi Arabia is a developing country whereas the UK is a developed one, it is understandable that the two countries differ in the development and sophistication of their securities markets. Thus, the research attempts to compare like for like by focusing on a specific type of intermediaries in secondary capital markets that exists in both countries, namely brokers working in secondary shares and bond markets.

Traditionally, a significant amount of discussion in legal studies focuses on the vital importance of periodic disclosure and corporate governance, with rather less attention devoted to trading in secondary markets itself. However, it is very difficult to ignore or minimize the role of trading in modern secondary capital markets, given

⁷ Roy Girasa, 'Commentary: The Quiet Revolution: The Opening of Saudi Arabia Securities Market to the West' (Luben School of Business Newsletter, Pace University, May 2005) 3-7 <<http://www.pace.edu/emplibrary/GlobalFinanceNewsletterFeb05.pdf>> accessed 29 June 2011

their large size relative to the overall size of the economy. Within the countries examined in the present research, for instance, the size of market capitalization of listed companies (i.e. listed in an organised exchange) to GDP in the UK was 69.3% in 2008.⁸ In other words, public companies that list their shares have a value equal to two-thirds of the entire British economy, even taking into account the collapse of prices because of the financial crisis in 2007.⁹ More fundamental to this investigation, the value of traded stock in equity markets (a secondary market) to GDP was 242.5% in 2008, or in other words more than double the size of the entire British economy.¹⁰ Given that the GDP of the British economy in 2008 in dollar terms was \$2,674,060,000,000, one may readily appreciate how big secondary capital markets are. Irrespective of current developments in bonds markets in Saudi Arabia, similar numbers are found there as well. The market capitalisation of listed companies in the formal exchange in Saudi Arabia was over 85% of the size of the economy.¹¹

From a public policy perspective, there are various justifications of the importance of secondary capital markets for both the UK and Saudi Arabia. In particular, there is a need to transfer public ownership to private agents, a fact that is not confined to developing countries or countries shifting towards market orientation policies since even well-developed countries rely on such processes. For example, the public support that banks in the UK received during the financial crisis of 2007 resulted in the state holding major stakes in some financial institutions. The government has indicated that it will dispose of its holding to the private sector as soon as the market stabilises and appropriate prices can be obtained for these

⁸ The World Bank, 'World Development Indicators' <<http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS>> accessed 29 June 2011

⁹ Before the 2008 financial crises, capital markets capitalization between 2005 and 2007 was on average 135% of the entire British economy. World Bank, 'Market Capitalization of Listed Companies (% of GDP)' <<http://data.worldbank.org/topic/financial-sector>> accessed 29 June 2011

¹⁰ Ibid

¹¹ Ibid

holdings. One of the options available to the government is to offer its holding to the public. Another option is to sell them directly to private investors. Underlying these two options is the availability of secondary markets for these holdings in facilitating the selling process as well as appropriate sums being generated from the process without huge discount.

Part II Aims and Objectives

The main aim of the thesis is to conduct an evaluation of regulatory duties supported by private causes of actions related to investor protection in secondary securities markets in general, and capital markets in particular. These duties are provided by regulations concerning the brokerage business in Saudi Arabia which are evaluated with comparative reference to those which prevail in the UK. The thesis focuses mainly upon the substantive regulatory protection provided where a broker offers the services of executing orders and giving advice, and links that framework of protection to the wider context of the legal system in each country.

However, a pure textual analysis without appropriate consideration given to the complexity surrounding transactions such as those pertaining to an investment brokerage relationship would be insufficient. Current epistemological methods warn against evaluating the substantive content of legislation while ignoring the context within which the law operates.¹² This is also true in determining the effectiveness of a regulatory framework in achieving optimal legal standards for an effective, modern securities market.¹³

Consequently, the principal question asked in this thesis is structured so as to take into consideration the above mentioned points, asking: are regulatory duties

¹² Andrzej Rapaczynski , ‘The Roles of the State and the Market in Establishing Property Rights’ (1996) 10 *Journal of Economic Perspectives* 2, 87-103

¹³ *Ibid*

introduced on the basis of investor protection supported by private causes of action in secondary securities markets, such as by the CMA in Saudi Arabia and the FSMA in the UK, effective in providing a framework for the private enforcement of applicable behavioural standards to retail investors? This principal question is complemented by the following, more specific questions:

(1) Should policymakers be concerned with the regulation of securities markets in general, and secondary securities markets in particular? If the answer to this question is 'Yes', then it must be asked to what extent is it justified that a government should be involved? To put the matter differently, what makes securities markets differ from other markets, such as car sales or maintenance services, so as to supports the currently fashionable perception that securities markets are better off with regulations?

(2) Is investor protection pursued by the state using specific laws, through the provision of regulatory obligations and remedies in secondary securities markets, a desirable legal objective? Empirical research shows that the priority accorded to protecting investors against unacceptable behaviour within financial markets correlates positively with the strength of a country's capital markets.¹⁴ Given a positive relationship between the quality of the legal environment and the development of capital markets,¹⁵ the critical inquiry would seek to determine whether or not private enforcement of regulations is part of these laws, standards and legal

¹⁴ Coffee (n 1); Bernard S. Black, 'Information, Asymmetry, the Internet, and Securities Offerings' (1998) 2 *Journal of Small and Emerging Business Law* 91, 98

¹⁵ Ross Levine, 'Financial Development and Economic Growth: Views and Agenda' (1997) 35 *Journal of Economic Literature* 688; Ross Levine, 'The Legal Environment, Banks, and Long-Run Economic Growth' (1998) 30 *J.M.C.B.* 596, 603

institutions which are necessary for the optimal functioning of capital markets in a country.¹⁶

(3) Should those who draft legislation and hence shape securities markets law within a country take into account the social and political context in addition to economic and administrative considerations? Studies of political economy emphasise the importance of recognising the economic interests which are at stake in determining the applicability and enforceability of regulation.¹⁷ It is therefore reasonable to expect a linkage between particular economic interests, working through, but not confined to, the commercial activities of brokerage firms and other financial market participants such as banks and pension funds, and the policy process which regulates and supervises the national securities markets. This linkage may find expression in a regulator's powers and jurisdiction over securities markets that emerge from the legislative process.

(4) Finally, what are the effects of the importation of legal rules and principles that have characteristics foreign to a national legal system, especially in the case of securities markets regulation? This thesis shows, in line with previous comparative research, that a common national response to the perceived need for legal reform is to borrow rules, principles, or procedures from different legal jurisdictions, and sometimes from different legal families, in order to achieve similar outcomes.¹⁸ Hooker points out a side-effect associated with such legal borrowing; it leads to the

¹⁶ For a literature review on the subject see Mathias Siems and Simon Deakin, 'Comparative Law and Finance: Past, Present and Future Research' (2010) 166 *JITE* 120

¹⁷ Effi Benmelech and Tobias J. Moskowitz, 'The Political Economy of Financial Regulation: Evidence from US State Usury Laws in the 18th and 19th Century' (AFA 2007 Chicago Meetings Paper, March 2006) < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891663 > accessed 29 June 2011; Erlik Berglof and Patrick Bolton, 'The Great Divide and Beyond: Financial Architecture in Transition' (2002) 16 *Journal of Economic Perspectives* 77

¹⁸ Katharina Pistor, 'Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies' (2004) 1 *EBOR* 59

pluralism of legal principles within a legal system.¹⁹ The thesis, thus, seeks to analyse not only questions of the existence of plural legal systems for the protection provided to investors in Saudi Arabia and the UK, but also to critically appraise the practice of pluralism within legal systems in terms of the strength of securities markets and economic growth.²⁰

In contextualising the above questions and approaching the afore-mentioned issues, the thesis initially identifies the nature of the general legal institutions in both countries which support secondary securities markets in general and securities markets in particular. To this end, the discussion is extended to cover those areas of general law which deal with tort law, regulatory bodies and the attendant private enforcement frameworks in both countries. Particular regard is paid to the contours of the regulatory structure throughout the history of securities markets regulatory systems in the UK and Saudi Arabia. This does not mean, however, that the thesis ignores traditional substantive law, such as agency and tort. These aspects are examined as part of the process of evaluating regulatory obligations.

Part III Theory, Methodology and Literature

A) Theory

It is generally recognised that securities markets enjoy a significant role in facilitating economic growth and, subsequently, increasing the standard of living for national citizens.²¹ This significant role is enacted through enhancing the utilization of national

¹⁹ M. B. Hooker, *Legal Pluralism: An Introduction to Colonial and Neo-colonial Laws* (Clarendon Press 1975)

²⁰ For the determination of the effectiveness of pluralism in substantive law, see Ihsan Yilmaz, *Muslim Laws, Politics and Society in Modern Nation States* (Ashgate 2005) 25

²¹ Thorsten Beck, Ross Levine and Norman Loayza, 'Finance and the Sources of Growth' (Policy Research for The World Bank 2057/1999, 1999) < <http://ssrn.com/abstract=569227> > accessed 29 June 2011; Aubhik Khan, 'Financial Development And Economic Growth' (2001) 5 *Macroeconomic*

savings and wealth as well as attracting foreign investment.²² The theory underpinning this thesis is that a successful national securities market which functions well in terms of size, liquidity and integration within global financial markets requires strong securities laws and institutions.²³ To that end, law and regulations which protect investors in secondary securities markets have been recognised as an important element.²⁴

However, ‘financial law’ may be seen as shorthand for a complex system according to which firms and finance are structured and controlled; citizens are protected and encouraged to invest and insure; and governments control, promote and apply social policies. Despite the fact that many relevant rules are provided by the state, the objectives, protection and structure of incentives and priorities in the legal system are deeply embedded in the political, social, and economic infrastructure. An extended inquiry into regulatory obligations therefore requires a deeper investigation of the institutional and historical structure of the entire economy. Regulatory obligations, hence, are considered here as a means to develop a much larger array of institutional arrangements and to analyse the fitness of regulatory regimes in suiting national economic and legal requirements.

There are three justifications for the focus of the thesis on the regulatory obligations of those providing brokerage services in securities markets. The first is the

Dynamics 413; Chaido Dritsaki and Melia Dritsaki-Bargiota, ‘The Causal Relationship Between Stock, Credit Market and Economic Development: An Empirical Evidence for Greece’ (2005) 38 *Economic Change and Restructuring* 413

²² Nicholas Apergis, Katerina Lyroudi and Athanasios Vamvakidis, ‘The Relationship Between Foreign Direct Investment and Economic Growth: Evidence From Transition Countries’ (2008) 15 *Transition Studies Review* 37. For a review of literature on the relationship between law and foreign investment see Amanda J. Perry, ‘The Relationship Between Legal Systems and Economic Development: Integrating Economic and Cultural Approaches’ (2002) 29 *Journal of Law and Society* 282, and by the same author ‘Effective Legal Systems and Foreign Direct Investment: In Search of The Evidence’ (2000) 49 *International & Comparative Law Quarterly* 779

²³ Levine and Zervos (n 1)

²⁴ Katharina Pistor, ‘Law as a Determinant for Equity Market Development: The Experience of Transition Economies’, a chapter in Peter Murrell (ed) *Assessing the Value of Law in Transition Economies* (University of Michigan Press 2001) 250

importance of the securities market itself and of credit and liquidity intermediation as an instrument of general economic development. It has been pointed out that, in developed countries, the control of capital has shifted from private financial institutions such as banks and wealthy investors to public markets.²⁵ In contrast, the markets for credit in developing countries are still dominated by financial institutions, and are still far smaller in terms of market capitalisation than those in developed countries.²⁶ So it could be maintained that any legal system that restrains the development of capital markets in an economy cannot reap the rewards of modernisation. Secondly, Pistor's research has drawn attention to the relevance of the law of obligations in secondary markets to investors and potential investors in such markets.²⁷ Such factors are of paramount importance for the ability of strong capital markets to deliver their intended economic rewards.

Finally, the influence of substantive law in economic development is well established. Some scholars refer to Max Weber's assertion that 'rational law' supports economic activities by lending predictability and legitimacy to the rules of market exchange.²⁸ Others prefer to cite Hayek, who asserted that common law is better suited to economic development than civil law on the basis that the former imposes constraints against the authority of government.²⁹ Whether substantive law is vital because it provides predictability and legitimacy or because it assures economic agents that governments will be restrained from unjustified intervention, economic research has been able to identify some impacts of substantive law on the way that economies develop. For instance, some economists link aspects of economic structure such as

²⁵ Michael Milken, 'Prosperity and Social Capital' *Wall Street Journal*, 23 June 1999; Waleed Alajlan, 'Ownership Pattern and The Saudi Market' (2004) 9 *Advances in Financial Economics* 161, 162

²⁶ *Ibid*

²⁷ Pistor (n 18)

²⁸ David Trubek, 'Max Weber on Law and the Rise of Capitalism' (1972) 1972 *Wis. L. Rev.* 720

²⁹ F. A. Hayek, *The Constitution of Liberty* (University of Chicago Press 1960); Paul Mahoney, 'The Common Law and Economic Growth: Hayek Might Be Right' (2001) 30 *Journal of Legal Studies* 503

size and liquidity of stock markets and concentration of ownership to the shareholder protection provided by the legal system.³⁰ Furthermore, a study by La Porta et al. suggested that, in recent history, countries with common law systems have experienced faster economic growth than those characterised as civil law systems.³¹ It is reasonable to try understanding how regulatory duties that affect contractual relationships subject to the general law can enhance economic development.

Given that there is a public interest in ensuring that financial law supports economic growth, it should be emphasised that law and regulations are not the only means available to a state to intervene in financial markets in general, or securities markets in particular. Generally speaking, there are a range of policy instruments, tools and methods at the disposal of a government to influence the operation of financial markets, the conduct of participants, or the ‘outcome’ of specific financial markets.³² These include surveillance, incentives with market-based solutions, ownership and control, guarantees, lending, subsidies, and regulation.³³

Nevertheless, regulation is seen as the most important and key tool in modern societies.³⁴ The term regulation is frequently used to refer to a technique of modern government whereby control is exercised (often through specialized agencies) over various aspects of social and economic life.³⁵ A regulation, thereby, is purposive in

³⁰ Randall Peerenboom, ‘What Have We Learned about Law and Development? Describing, Predicting, and Assessing Legal Reforms in China’ (2006) 27 Mich. J. Int’l L. 823, 866

³¹ Rafael La Porta and others, ‘Law and Finance’ (1998) 106 Journal of Political Economy 1113

³² See OECD publication, ‘Policy Framework for Effective and Efficient Financial Regulation’ (2009) 2 Financial Market Trends 267, 272

³³ Ibid

³⁴ It is claimed that ‘[c]apitalism is manifested in the emergence of civil regulation as an alternative, complementary and innovative form of regulatory governance’, David Levi-Faur, ‘Regulatory Capitalism and the Reassertion of the Public Interests’ (2008) 27 Policy and Society 181

³⁵ Simon Halliday, *Judicial Review and Compliance with Administrative Law*, (Hart Publishing 2004) 10; Steve Tomb, ‘Book Review: Understanding Regulation’ (2002) 11 Soci. & Leg. 113. Baldwin and Cave note that the term regulation is used in three different senses: (1) a specific set of commands; (2) deliberate state influence; and (3) all forms of social control or influence; see Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy and Practice* (OUP 1999) 2

orientation;³⁶ it seeks to implement particular collective goals which are considered by the community to be socially valuable and worthy of pursuit but which would not otherwise be achieved, or would not be likely to be achieved, in the absence of regulation.³⁷ Accordingly, throughout this thesis, the term ‘regulation(s)’ focuses on the state as a purposeful actor; this does not, however, in any sense seek to deny the significance of private actors and societies in the regulatory process.³⁸ Their impact on government policies or a regulatory agency in securities markets should not be neglected, and hence special reference is made where relevant to the influence of private actors on the shaping of regulation.

However, in recent years, there has been an increasing volume of literature on the need to investigate the impact of various formal and non-formal factors that may affect financial markets. Current legal discussions in respect of state intervention suggest that the entire panoply of methods and instruments which regulators use, and their consequences for financial markets, should be examined. This approach is given formal expression by the term ‘the regulatory regime’.³⁹

Although differences of opinion still exist, there appears to be some agreement that a ‘regulatory regime’ refers to a wider concept than merely the substantive content of the prevailing set of rules established by regulatory agencies.⁴⁰ The concept encompasses external factors other than regulations that have a demonstrable impact

³⁶ Baldwin and Cave, *ibid.*

³⁷ The particular collective goals will vary depending on the scheme in questions. Those goals could be economic, political or social; see Karen Yeung, *Securing Compliance: A Principled Approach* (Hart Publishing 2003) 6

³⁸ For a theoretical discussion of the role of the state in governing through regulation see Colin Scott, ‘Regulation in The Age of Governance: The Rise of The Post Regulatory State’ in Jacint Jordana and David Levi-Faur (eds) *The Politics of Regulation : Institutions and Regulatory Reforms for The Age of Governance* (Edward Elgar Pub 2004)

³⁹ Jeffrey Carmichael and Michael Pomerleano, *The Development and Regulation of Non-bank Financial Institutions* (World Bank 2002) ch.2; David Llewellyn, ‘The Optimal Regulatory Environment’ in Thea Kuppens, Henriëtte Prast and Sandra Wesseling (eds.), *Banking Supervision at the Crossroads* (Edward Elgar 2003)

⁴⁰ *Ibid.*

on financial markets. There is no complete list to include all such factors,⁴¹ but Llewellyn's description may be the clearest. He lists seven elements of a regulatory regime:⁴² (1) the rules established by regulatory agencies; (2) monitoring and supervision by official agencies; (3) the incentive structures faced by regulatory agencies, consumers and institutions; (4) the role of market discipline and monitoring; (5) intervention arrangements in the event of a failure of a financial institution; (6) the role of internal corporate governance arrangements within financial institutions, and (7) the disciplining and accountability arrangements applied to regulatory agencies. It was hoped that the present research would have been able to cover all these factors, but given limited space and time this thesis focuses mainly on the first factor and builds upon previous research regarding theory and practice.

Having said that, considerable developments have occurred in the last twenty years in the theory of securities regulations in general, and securities market in particular. Since La Porta et al.'s study mentioned above,⁴³ extensive economic research has begun to suggest a causal relationship between common law and economic growth, often concluding that common law represents 'good law'.⁴⁴ Subsequently, good law for commerce, including financial markets, corporate governance and shareholders rights, has been equated with Anglo-American law.⁴⁵ The collapse of the Soviet Union and the development of economic globalization can be seen as putting such perceptions into practice. Many countries have faced serious institutional challenges as a result of one or other of these two factors (sometimes

⁴¹ For instance, it is argued that there are four components: (1) regulatory objectives; (2) regulatory structure; (3) regulatory backing, and; (4) regulatory implementation; see Carmichael, and Pomerleano, Llewellyn, *ibid*

⁴² Llewellyn (n 39)

⁴³ La Porta and others (n 31)

⁴⁴ Curtis Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development Around the World* (Univ. of Chicago Press 2008) 2

⁴⁵ 'In our pool of models today we see Western legal systems competing to become the ones selected for foreign import' Esinn Öricü, 'Critical Comparative Law: Considering Paradoxes for Legal Systems in Transition' (2000) 4(1) Web EJCL17 <<http://www.ejcl.org/41/abs41-1.html>> accessed 29 June 2011

both) and have been confronted with severe national macroeconomic problems. Those countries turned, either voluntarily or under external pressure from international organisations, to a prepared standard menu of legal reforms which was clearly based on what were perceived to be ‘good laws’ for economic growth and/or to attract foreign investment.⁴⁶

However, the failure of certain transformation attempts,⁴⁷ combined with the economic success of countries which do not subscribe to the same concepts of either ‘good laws’ or the role of law as identified by Western countries, such as China, led Milhaupt and Pistor to suggest that present trends require a perspective different from what was previously received wisdom about law and development.⁴⁸ They argue that what was thought of as such common wisdom was not actually an understanding of how law and the economy interact, but rather about the relationship between law and capitalism.⁴⁹ Moreover, the application of theories of how law influences economic development has been subject to criticism by scholars who question the basic assumptions and models upon which such practice is based.⁵⁰ It is then proposed that assumed relationships between legal frameworks and economic growth and development should be thoroughly re-examined.⁵¹

As far as secondary securities markets are concerned, a notable type of current explanation that attempts to explain national difference concerns the role of

⁴⁶ For a literature review on the matter, see Gail Edward, ‘Legal Transplants and Economics: The World Bank and Third World Economies in the 1980s - A Case Study of Jamaica, the Republic of Kenya and the Philippines’ (2007) 9 E.J.L.R. 243

⁴⁷ Ibid

⁴⁸ Milhaupt and Pistor (n 44)

⁴⁹ Ibid, 3

⁵⁰ Ibid

⁵¹ Sheila Dow, ‘Mainstream Methodology, Financial Markets and Global Political Economy’ (2008) 27 Contributions to Political Economy 13, 14; Kevin E. Davis and Michael J. Trebilcock, ‘The Relationship Between Law and Development: Optimists Versus Skeptics’ (2008) 56 Am. J. Comp. L. 895; Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (OUP 2003). In relation to legal transplantation and the individual, see Michele Graziadei, ‘Legal Transplants and the Frontiers of Legal Knowledge’ (2009) 10 Theoretical Inq. L. 723

enforcement in the effectiveness of regulatory regimes. In a realist view of the world, the proposition that the law on the books does not fully capture the significance of a legal regime is uncontroversial. Consequently, it is often accepted that agents within a certain market may not pursue their rights against other agents. This may, in cases left without intervention, lead to undesirable consequences for both agents (such as lack of mutual confidence) and for the market itself (for example, a decrease in demand).⁵²

It is thus argued that:

‘[l]egal mechanisms for correcting of popular capitalism's mistakes in the regulatory state now range more widely beyond those of traditional private law enforcement by victims *to include important enforcement and recovery mechanisms that are firmly embedded in statute and initiated by a statutory body*’.⁵³

In explaining the differences in outcomes among countries that have adopted similar securities markets reforms, it is then proposed that it is the differences in ‘regulatory intensity’ among countries that have resulted in different efficiency outcomes irrespective of the similarities in regulatory measures taken.⁵⁴

Thus, a recent research trend has started to look at the enforceability of the regulatory protection of investors in reality, rather than at the law on paper. The first study to empirically compare enforceability between two major common law

⁵² This is not confined to financial markets, but has expanded to the communications and electricity industries, for example.

⁵³ (emphasis added) Joanna Gray, ‘The Legislative Basis of Systemic Review and Compensation for the Misselling of Retail Financial Services and Products’ (2004) 25 Stat. L.R. 196

⁵⁴ Regulatory intensity in general is defined as ‘the level of regulatory intervention, the appropriateness of particular devices (disclosure, operational controls and liquidity controls, for example) and the effectiveness of supervision ... assessed across all policy areas’ in Kern Alexander and others, ‘Transatlantic Financial Services Regulatory Dialogue’ (2006) 7 EBOR 647, 652

jurisdictions was published in 2005.⁵⁵ That study contrasted the financial authorities in the United States and UK jurisdictions with regards to enforcement intensity in securities markets by the regulatory agencies. The problem that faced the researcher was how intensity was to be measured, and it was subsequently decided to rely on the amounts of money generated by each authority in settlements and fines. The paper's main finding was that fines, settlements and restitution in the US were relatively higher than those in the UK, taking into account adjustments for size of GDP as well as the size of the capital market.⁵⁶ A second study concerned with enforcement attempted to approach the subject differently by looking at agents of enforcement within securities market.⁵⁷ The study compared the two jurisdictions by measuring different inputs as factors influencing enforceability, such as the number of cases handled by the authorities, and the size of enforcement department staff, among others. The researchers then evaluated those factors against the outcomes generated from the previous study in 2005, arriving at the same conclusion; that enforcement intensity in the UK is less than in the US.

It could be argued that the recent research interest in regulatory enforcement faces some issues which need to be addressed. In particular, it is still controversial as to what may be deemed appropriate comparative factors to be utilized in this area of research.⁵⁸ Furthermore, numbers do not tell the whole story; differences in the

⁵⁵ Howell Jackson, 'An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity' (Harvard Law and Economics Discussion Paper No. 522, 2005) <<http://ssrn.com/abstract=839284>> accessed 29 June 2011

⁵⁶ The paper has been criticised on the basis that the data for combined sums collected by the researcher does not include the powers; the SEC, for example, includes money paid to investors as a result of settlement reached with firms. Such an approach may lead to biased conclusions; John Coffee, 'Law and the Market: The Impact of Enforcement' (Weiss Centre Working Paper 07-3/2007, 2007) <<http://finance.wharton.upenn.edu/weiss/papers2007.html>> accessed 29 June 2011; Howell Jackson and Mark Roe, 'Public and Private Enforcement of Securities Laws: Resource-Based Evidence' (2009) 93 *Journal of Financial Economics* 207

⁵⁷ Coffee, *ibid*

⁵⁸ See Howell Jackson, 'Response, The Impact of Enforcement: A Reflection' (2008) 156 *U. PA. L. Rev.* 400

institutional structures of the countries could affect the data collected. For example, there is currently a unitary authority to deal with financial markets in the UK and it pursues different regulatory objectives, including but not limited to the supervision of banking and setting prudential standards for financial institutions. Whereas many agencies in the US, both at federal and states level, have roles in enforcement but are not included in the scopes of either study.⁵⁹ In other words, the problem with the comparative assessment of comparative regulatory enforcement intensity is the lack of consensus on assessment methodology.

Thus, the present study investigates the origins of prevailing theories concerning the way in which knowledge about securities market law and the economy is variously construed and constructed, and the role that such different understandings play in theory, policy and practice.⁶⁰

It may be suggested that the best criteria for designing a regulatory regime capable of accomplishing its intended purposes will involve effectiveness and efficiency. The term effectiveness relates to whether the objectives are met, while efficiency relates to them being met in an efficient way without imposing unnecessary costs on consumers or regulated firms.⁶¹ Cost here is not limited to cost-benefit analysis; it also includes direct and indirect costs borne by individuals and firms in compliance.⁶² Accordingly, it is pointed out that a regulatory structure should ensure that there are no excessive compliance costs, which might diminish the competitiveness of a country in global financial markets and increase the costs of

⁵⁹ The study conducted by Coffee (n56) includes figures from class-action cases in the US in assessing the overall redress mechanisms with the US. The paper, though, does not include figures from statutory alternative disputes resolution, which plays an important role in the UK which is likely to be due to the lack of availability of data in this respect.

⁶⁰ For a financial explanation see Joseph Stiglitz, 'The Role of The State in Financial Markets' World Bank Research Observer, Annual Conference on Development Economics Supplement 19

⁶¹ Llewellyn (n 39) 17

⁶² See for an example Julian R. Franks, Stephen M. Schaefer and Michael D. Staunton, 'The Direct and Compliance Costs of Financial Regulation' (1997) 21 Journal of Banking and Finance 1547

services and products for recipients in national markets.⁶³ To avoid excessive compliance costs, various precautionary measures may be suggested. For instance, Goodhart warns against investing excessive authority in a regulatory agency, which might easily fall into the trap of over-regulation, because:

‘[T]he incentive for regulators, especially when they do not bear the burden of costs themselves, is to impose such comprehensive regulations that they will not personally be likely to be held responsible for failures and failing during their own term of office. Since success for a regulator, when the costs of regulation are not taken fully into account, can be measured by the absence of newsworthy failures, the incentive will be for over-regulation’.⁶⁴

While a considerable amount of researches focuses on public enforcement, researches as to the role of regulatory private enforcement has attracted little attention in comparison. Thus, a separate section in this thesis specifies the relationship between public enforcement and private enforcement by emphasising the three necessary conditions provided by the state for the existence of financial markets: substantive law, enforcement of contracts and dispute settlement. The aim here is to determine what is essential in achieving effectiveness in securities markets, without regards to arguments that a compromise needs to be made between efficiency and effectiveness. This realistic strategy should help in understanding which elements are important but may take different forms in different legal systems.

⁶³ Ibid

⁶⁴ Charles Goodhart, *The Central Bank and the Financial System* (MIT Press 1995) 451. It is also suggested by Schooner and Taylor that: ‘regulators must respond to the demands of a diverse constellation of conflicting interests’, and thus regulators will prioritize ‘... the demands of these different audiences’, Hedi Mandanis Schooner and Michael Taylor, ‘Convergence and Competition: The Case of Bank Regulation in Britain and the United States’ (1999) 20 Mich. J. Int'l L. 653

It should be noted that, whereas this thesis discusses Saudi Arabia and the UK, it does so with the full knowledge that the former is considered to be a traditional country which applies Islamic principles⁶⁵ and that its economy is not capitalist in orientation.⁶⁶ While Islamic finance provides theories and practices which have generated alternatives to the transactions in commercial or traditional banking and capital markets (such as *sukuk*), these developments have not reached such a level as to be the foundation of a new paradigm of an overall regulatory structure in Muslim countries. The existing regulatory structures are based on concepts that were developed by Western countries.⁶⁷ The lack of such a paradigm, among other factors, is probably the reason why transplanting legal rules has become the centrepiece of government efforts to meet development needs and to accommodate new economic policies in Saudi Arabia. The lack of specifically Islamic paradigms could help in explaining why the draftsmen of the CML relied upon foreign law and imported rules and institutions in order to develop the legal system of capital markets in Saudi Arabia.⁶⁸ This would support Watson's claim that 'most changes in most systems are the result of borrowing'.⁶⁹

However, this approach to developing financial law calls for an inquiry into theories of legal transplant and legal borrowing. For a start, the question arises as to the capability of legal rules transferred from one legal system to another to fit their

⁶⁵ For a detailed discussion of the Islamic legal culture, see Lawrence Rosen, *The Justice of Islam: Comparative Perspectives on Islamic Law and Society* (OUP 2000); Patrick Glenn, *Legal Traditions of the World* (2ed ed, OUP 2004); Lawrence Rosen, *Varieties of Muslim Experience: Encounters With Arab Political and Cultural Life* (University of Chicago Press 2008)

⁶⁶ Amr Marar, 'Saudi Arabia: The Duality of the Legal System and the Challenge of Adapting Law to Market Economies' (2004) 19 Arab L.Q. 91

⁶⁷ Girasa (n 7)

⁶⁸ Joseph Beach, 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets' (2005) 41 Stan. J. Int'l L. 307. The importance of this paper is that it is the only paper that gives insights as to the legislation drafting process in Saudi Arabia for the CML by a co-drafter of the act.

⁶⁹ Alan Watson, *Legal Transplants: An Approach To Comparative Law* (University of Georgia Press 1993) 111

new environment, regardless of the legal, social and political order in which they were initially created. Disagreements in the literature on this matter reflect contrasting understandings of the relationship between the legal rules and the society in which they are created.⁷⁰ In his seminal book 'Legal Transplants', Watson argues that law is independent and autonomous and, hence, there is no relationship between it and society. Legal rules are transplanted because they are basically inherently good ideas and hence there is no need for systemic analysis.⁷¹ At the other extreme, Kahn-Freund claims that laws are not autonomous, and cannot be separable from their purpose or the circumstances in which they are made.⁷² So, according to Khan-Freund, even when there is a common objective, transplanting law from elsewhere will rarely work.⁷³ The spectrum of opinion between these two extreme views aims to determine the feasibility of legal transplants.⁷⁴ The range of theory in this field is of vital importance for the present study as the regulatory duties examined of 'suitability' and 'best execution' were both transplanted into the case study countries.

More recent literature on legal transplantation shifts the focus from the content of the law itself to the law-making process, ascribing importance to political factors and motivations as elements that determine the success or the failure of legal transplants. Taking into consideration the importance of such views in supporting the

⁷⁰ Hideki Kanda and Curtis Milhaupt, 'Re-examining Legal Transplants: The Director's Fiduciary Duty to Japanese Corporate Law' (2003) 51 Am. J. Comp. L. 889

⁷¹ Watson (n 69). See also Miller who points out that '... academic scholarship has identified transplants virtually in every area of law', Jonathan Miller, 'Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process' (2003) 51 Am. J. Comp. L. 839, 841; Alan Watson, 'Legal Change: Sources of Law and Legal Culture' (1983) 131 U. Pa. L. Rev. 1136, 1135-1136; Jan M Smits, 'The Harmonisation of Private Law in Europe: Some Insights from Evolutionary Theory', (2002) 31 Special Volume in Honor of Alan Watson, Georgia Journal of International and Comparative Law 79

⁷² O. Kahn-Freund, 'On Use and Misuse of Comparative Law' (1974) 37 Modern Law Review 1

⁷³ Ibid

⁷⁴ For example, it is suggested it will depend on the 'universalism' of the legal rule itself and the 'cultural relativism' in William Twining, 'Generalizing About Law: The Case of Legal Transplants' The Tilburg-Warwick Lectures 2000: General Jurisprudence, (Lecture 4) <<http://www.ucl.ac.uk/laws/jurisprudence/publications.html>> accessed 29 June 2011

utilization of the law as an economic tool in the last twenty years, such a conception poses its own theoretical challenges.⁷⁵ Experience shows that the effective usage of law as an instrument of economic development may vary among different legal systems, let alone between different legal cultures.⁷⁶ In some instances there may be flaws in what is formally proclaimed as law;⁷⁷ in others a perfectly sound law may fail to accomplish its purpose because of lack of implementation⁷⁸ or of pluralism in the political environment.⁷⁹

Because of the uncertainty over and disagreement about the nature of the legal transplantation process, a methodological difficulty arises in what measurements must be made in order to define the ‘success’ or otherwise of a legal transplantation. The provisions of the CML in Saudi Arabia were imported from sources in United States, Europe, Asia, and the Middle East, which makes it difficult to specify one country as the donor.⁸⁰ Consequently, given the lack of tools for measuring its success, this thesis is not concerned with the evaluation of the transplantation process *per se*. Rather, it seeks to compare the regulatory regimes for secondary securities markets in Saudi Arabia and the UK on the basis of whether or not they achieve what a regulatory regime is expected to achieve. Questions of appropriate frameworks, standards and criteria for the success of the evaluation process are therefore important and these concerns are dealt with next.

⁷⁵ The purpose of law as an instrument is seen as being ‘essentially one of problem solving in which solutions developed elsewhere are imported to solve local problems’ William Twining, ‘Diffusion of Law: A Global Perspective’ (2004) 49 J. Legal Pluralism & Unofficial L 1, 20

⁷⁶ ‘The whole structure of law in a non-Western society is, seen from a cultural point of view, formed in the interaction between received law and indigenous law’ Masaji Chiba, *Asian Indigenous Law: In Interaction With Received Law* (KPI 1986) cited in Warner Menski, *Comparative Law in a Global Context: The Legal Systems of Asia and Africa* (CUP 2006); David Nelken, ‘The Meaning of Success in Transnational Legal Transfers’ (2001) 19 Windsor Y.B. Access Just. 349, 351

⁷⁷ Rudolf Schlesinger, *Comparative Law: Cases, Text, Materials* (Foundation Press 1998) 317

⁷⁸ *Ibid*

⁷⁹ In the absence of pluralism, law is used as a ‘mechanism for the entrenchment and legitimization of state power’ in Lan Cao, ‘Book Review: Law and Economic Development: A New Beginning?’ (1992) 32 Tex.Int’l L.J., 544, 550

⁸⁰ Beach (n 68)

B) Methodology: A Library-Based Comparative Case Study

The aim of this is to analyse in depth the effectiveness of the implementation of regulatory duties in secondary securities markets provided by the regulatory regime in Saudi Arabia, taking the regulation of brokerage business as an example. While it is acknowledged that there are several components of a regulatory regime,⁸¹ substantive standards and the content of regulation are nonetheless still central. It is the enforcement of these duties not by regulatory agencies but rather by investors themselves that the present study attempts to evaluate.

Accordingly, the thesis targets a gap in the literature dealing with securities regulation in Saudi Arabia by focusing on three areas: (1) the regulatory regime in Saudi Arabia, (2) the regulatory duties and remedies provided by the regulatory regime, and (3) the role enjoyed by the main institutions which apply the law in the secondary securities markets, namely the judicial system and the regulatory agency. Given these considerations, both the methodology and the methods of the research were developed accordingly.

B.1. Comparative Study

In achieving the research aims and answering the questions posed, various potential methodologies have been rejected in favour of a comparative approach. Such an approach can be conducted not only among different countries but also within a specific country. Within a domestic context it can help in evaluating a given situation

⁸¹ Such as supervision and market discipline For a detailed list, see David Llewellyn, 'A Regulatory Regime for Financial Stability' in George G. Kaufman (ed), *Research in Financial Services: Private and Public Policy: v. 12 Bank Fragility and Regulation: Evidence from Different Countries* (JAI 2000)

before and after particular events. This research focuses on state intervention in secondary securities markets through the establishment of a regulatory regime, which hence is the incident which the domestic analysis in this comparative study focuses on. The inclusion of this domestic comparative analysis is of considerable benefit. Firstly, it helps in the appraisal of policy achievements and hence the ability of the system to meet the needs of the economy. Secondly, an appraisal of implementation can determine whether or not the system or process of policy change through regulations has been effective in achieving the intended economic and social changes. Thirdly, it can help to discover a regulatory pattern in one policy domain, such as capital market regulation, so that we would be in a position to predict comparable regulatory patterns in other domains within the same nation.⁸²

This study also conducts a comparative analysis between two different jurisdictions, namely the UK and Saudi Arabia. From the point of view of the main research question of the thesis, comparative techniques allow an objective appreciation of any given system through an evaluation of the applicability of different theories to the social and economic context of national institutions.⁸³ Moreover, the preference for a comparative methodology is based on other grounds. Firstly, it is noted that the comparative methodology represents a valuable tool in taking into account the cultural and social characteristics of the financial legal system

⁸² David Vogel, *National Styles of Regulation. Environmental Policy in Great Britain and the United States* (Cornell University Press 1986); Susanne Lutz, 'Convergence Within National Diversity: A Comparative Perspective on the Regulatory State in Finance' (2004) 24 *Journal of Public Policy* 169

⁸³ George Fletcher, 'Two Modes of Legal Thoughts' (1981) 90 *Yale L.J.* 970, 999; Hugh Collin, 'Methods and Aims of Comparative Contract Law' (1991) 11 *Oxford J. Leg. Stud.* 396, 398; Ugo Mattei, 'Opportunity Not to Be Missed: The Future of Comparative Law in the United States' (1998) 46 *Am. J. Comp. L.* 709, who notes that: 'In the global world there is a fundamental need for sophisticated comparative scholarship that can be produced only by interdisciplinary efforts involving legal experts in basic research' 717

in Saudi Arabia.⁸⁴ Secondly, the conclusions drawn after applying such approach would then be likely to increase understanding of the national and global issues involved and encourage the development of global legal communication as well as, if possible, convergence. Thirdly, even if convergence of law would not be a direct benefit of the present study, it would, at least, enhance understanding of the nature of legal changes and how the law relates to other aspects of social life.

Moreover, a comparative analysis of the two countries is valuable in analysing potential ways forward with a view to accomplishing similar outcomes and increasing the possibility of harmonisation. It helps in providing practical recommendations for the development of capital regimes for capital markets.

B.2. Case Study

The thesis is based on a case study approach, which is defined as ‘the study of the particularity and complexity of a single case, coming to understand its activity within important circumstances’,⁸⁵ especially when the case in question ‘is of very special interests’.⁸⁶

Consequently, there are several grounds to justify the choice of this approach in achieving the objectives of this thesis. Most critically, the two countries began their regulatory reform programmes at different times, under very different circumstances,

⁸⁴ ‘Another distinctive feature of the theory of comparative law as a method of legal science is that it plays an important role in the interpretation of legal norms pertaining to various legal systems, as well as in the adaptation of one socio-legal system to another’ in Djalil Kiebaev, ‘Comparative Law: Method, Science or Educational Discipline?’ (2003) 7.3 Web EJCL <<http://www.ejcl.org/41/abs41-1.html>> accessed 29 June 2011

⁸⁵ Robert Stake, *The Art of Case Study Research* (Sage 1995), at xi

⁸⁶ *Ibid*

for different reasons. Interestingly, the variation in timing exists regardless of the fact that both countries are influenced by the phenomena of globalisation and deregulation and have worked closely in international organisations such as the International Monetary Fund (henceforth IMF) and the World Bank. Moreover, the analysis of the two cases may not test the same concepts and theories, due to each country's different history and conception of the meaning of the role of law.

In dealing with such complex settings of situations or events, the case study approach has been suggested to be best suited to the examination of a specific condition of the position of a particular case.⁸⁷ A case study approach is also deemed important when there is a lack of useful literature introducing the social, economic and cultural differences between the UK and Saudi Arabia and the subsequent legal impact of these factors.⁸⁸

Accordingly, it could be reasonably asserted that a case study approach is suitable for the present study, given the complexity imposed by the comparative methodology chosen as well as the lack of secondary sources concerned with Saudi Arabia.

The present author is aware that the approach applied in this research has some shortcomings. The choice of the case study as an approach requires that both of the states whose law is subject to comparison see their problems as similar, and that they are pursuing similar policy objectives which, if not identical, differ in clearly understood ways. It is deemed necessary, therefore, to select and compare similar problems and/or similar policy objectives. Accordingly, it is assumed that both

⁸⁷ See Jean Hartley, 'Case Study Research' in Catherine Cassell and Gillian Symon, *Essential Guide to Qualitative Methods in Organizational Research* (Sage 2004) 324

⁸⁸ Izak Benbasat, David K. Goldstein and Melissa Mead, 'The Case Research Strategy in Studies of Information Systems' (1987) 11 *MIS Quarterly* 396, 370

countries genuinely aim to implement the legal principles and objectives provided by the International Organisation of Securities Regulations (IOSCO) in their national contexts.⁸⁹

Moreover, the present cases were not selected from a random sample and it is possible, thus, that the selection itself may affect the conclusions drawn. Accordingly, it is a question of how to ensure that the chosen variables compared in the case studies have adequate explanatory powers. It is accepted that a mere assembly of different national sets of legislative enactments is not as effective as tracing them back to their origins. But by following such approach the present author would encounter various different political, economic and legal circumstances, about which data may not be available. For example, the evaluation of the regulatory context in Saudi Arabia lacks feedback from the judicial system, since case reporting in Saudi Arabia does not exist. Hence, the account given is neither complete nor comprehensive.

The difficulty with the lack of access to judicial decisions creates two major difficulties for the current research. Firstly, it becomes inevitable that speculation is necessary as to what the judicial interpretation of legislative texts within a regulatory regime might be. Secondly, it is impossible to compare the judicial interpretations of legal texts in the two countries, and therefore to exclude various explanatory factors such as differences between the two countries resulting from different judicial interpretations.

⁸⁹ IOSCO helps regulators to determine objectives, structure, and principles of financial markets. Its website states that 'IOSCO adopted in 1998 a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), which are today recognised as the international regulatory benchmarks for all securities markets. The Organization endorsed in 2003 a comprehensive methodology (IOSCO Principles Assessment Methodology) that enables an objective assessment of the level of implementation of the IOSCO Principles in the jurisdictions of its members and the development of practical action plans to correct identified deficiencies, <<http://www.iosco.org/about/index.cfm?section=history>> accessed 29 June 2011

The above-mentioned shortcomings are brought into the discussion wherever it is deemed possible that they are likely to influence the analysis or the conclusions drawn. It is thought this is the most appropriate way to deal with these shortcomings without undermining the value of the discussion.

B.3. Scope of the Research

The reasons for choosing the regulatory regimes of Saudi Arabia and the UK and for the discussion in the thesis to centre upon them are as follows. The present researcher is a Saudi Arabian national and his government sponsored the research described here. It was thought that he might orient his research to an area of direct interest and relevance to his sponsor by assessing its laws and regulations and making the identification of its defects one of the primary goals of this thesis.

However, other, less pragmatic grounds, also justify Saudi Arabia as a choice. The desire to increase access to foreign capital in the Saudi economy, as evidenced by recent changes in government policies, encounters the problem of a lack of research on the subject, which may itself increase the costs of attracting foreign investment. In its assessment of the compliance of securities regulations in Saudi Arabia with IOSCO principles, the Financial Standards Foundation notes that, as to the IOSCO principle that requires intermediaries' compliance with regulations aiming to protect the interest of clients, there 'is insufficient information publicly available addressing Saudi Arabia's compliance with this principle'.⁹⁰ Additionally, Saudi Arabia's

⁹⁰ Through its eStandardsForum, which 'promotes a sound, transparent, and equitable global economy. It collects and disseminates, as a public good, information on countries' compliance with global best

economy is evolving towards, rather than already possessing, market institutions. Therefore, the on-going experience of Saudi Arabia provides an opportunity to analyse the influence of law in facilitating the movement towards a market economy.

The choice of the UK as a case in this study has been made for reasons different from those used to select Saudi Arabia. Firstly, the UK has a long-established system of securities law; secondly, its regulatory regime has transplanted some regulatory duties from the US, and hence Saudi Arabia and the UK share some experiences. Thirdly, the UK has the most effective financial intermediations and markets based on, *inter alia*, existing policies and institutions according to the index of the Financial Development Report (FDR).⁹¹ In addition to being praised for having the most sophisticated regulations concerning securities markets, the FDR points out that financial intermediaries in the UK are world class, given top marks for insurance, securitisation, and merger and acquisitions activities, with better protection for minority shareholders and shareholder rights and extensive regulatory obligations. Therefore, it was initially thought that the present discussions could never be complete, and would be unable to properly enrich the field of legal studies, if the UK was excluded. For these reasons, the UK was chosen as the preferred case study.

Given the limitations imposed on this PhD research in relation to time, place, and cost, an extensive comparative study of regulatory obligations and remedies in the two systems would have necessarily been largely descriptive, hence impairing the quality of the discussion. Therefore, in order to produce a more significant and

practice standards' <<http://www.estandardsforum.org/saudi-arabia/standards/objectives-and-principles-of-securities-regulation>> accessed 29 June 2011

⁹¹ See World Economic Forum, The Financial Development Report 2009 (World Economic Forum 2009). The report is available online at <http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2009.pdf> accessed 29 June 2011. In the report of 2010 the UK is placed second after the US <http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2010.pdf> accessed 29 June

analytical study it was thought preferable to limit the scope of inquiry to certain duties and their remedies as provided by the regulatory regimes in each country. Accordingly, in evaluating the two regulatory regimes of the case studies, the thesis uses a ‘top to bottom’ approach by, firstly, analysing the regulatory regimes established in each country with special reference to their backgrounds; and, secondly, investigating thoroughly how the two countries have implemented regulatory requirements to serve particular duties. These concern a group of indispensable intermediaries in secondary capital markets, namely stockbrokers, for whom the chosen duties are suitability and best execution. It is thought that such an analysis provides both depth and breadth to the present evaluation.

B.4. Method: Library-Based Research

The thesis requires a method that suits the nature of this comparative methodology, the research aim, and the questions posed. As outlined above, the thesis adopts a case study strategy due to the complexity of the subject and, therefore, it is now a question of how to deal with the case studies. To this end, various methodological options were considered and rejected. Interviews and questionnaires were deemed unsuitable in providing evidence to evaluate the pre-intervention legal systems. Additionally, such methods would encounter practical barriers due to language differences and difficulties accessing subjects. Moreover, the possibility of subjective bias among individual actors involved in the system examined, along with the political, regulatory and commercial requirements of confidentiality would hinder any reliable evaluation.

In contrast, a library based method easily suits the objectives of the thesis, which conducts an examination of how financial law as it stands in reality meets the requirements of developing securities markets, and how differences between the two

countries may be objectively explained while at the same time pointing to the potential effectiveness of alternatives measures. Consequently, the nature of the present inquiry straddles various different disciplines, including law, finance, economics, and jurisprudence. It was thought, therefore, that library-based research was the most appropriate method since many aspects of the study require conceptual and critical analyses of the contents of different materials at hand, in addition to the effort needed to collect data.

C) Literature Review

Both primary and secondary sources feature widely throughout this thesis, the former comprising both formal instruments and case law, and a list of primary sources is included as well as a full bibliography detailing the secondary sources consulted.

C.1. Primary Sources

The thesis focuses mainly on the regulatory regimes created in the two countries, with close examinations of legislation and its effects, and, therefore, the starting point is legislation in respect of brokerage services, namely the CML for Saudi Arabia, and FSMA for the UK.

Additionally, a number of documents produced by international organisations are mentioned in the course of the discussion. These include IOSCO publications such as ‘IOSCO Objectives and Principles of Securities Regulation’ and ‘IOSCO Principles Assessment Methodology’. These documents set out three objectives and thirty principles upon which the regulation of securities markets is based, including the regimes in Saudi Arabia and the UK.

Other primary sources in the thesis take the form of case material. Important cases with regard to brokerage business and financial advice are available within the English jurisdiction, such as *JP Morgan Bank (formerly Chase Manhattan Bank) v Springwell Navigation Corp*⁹². Again, the absence of a reporting system for cases in Saudi Arabia makes it difficult to obtain details of judicial decisions and, hence, determine the judicial approach used and interpretation made of legal texts. Fortunately, there is a publication of the general principles reached by the Committee for Settling Banking Disputes, which has been of importance in providing insights into traditional tort principles in Saudi Arabia.

The publications by those authorities dealing with securities markets, including regulations, have been essential to the discussion and analysis in this research. Thus, the Financial Services Authority (henceforth FSA) materials in its Handbook, Policy Statements and other guidance have formed a major part of the primary resources used. In similar vein, the publications of the authority in Saudi Arabia, namely the CMA, that deals with the subject, such as its Conduct of Market Regulations (henceforth CMR) and Authorised Persons Regulations (henceforth APR), have been central subjects of discussion.

C.2. Secondary Sources

The nature of this inquiry dictates the examination of various different sources from a range of disciplines throughout the thesis, including those related to finance and economics, politics and political economy, the law, and theories of regulations.

⁹² [2008] EWHC 1186 (Comm)

Major works in finance and economics such as Stiglitz', 'The Role of The State in Financial Markets' discuss the importance of states in financial markets. Within the sphere of the relationship between financial markets and economic growth, different works by Levine have been prominent in discussions of relations between finance and the economy in the last decade, such as 'Finance and the Sources of Growth', 'Financial Functions, Institutions, and Growth', and 'Financial Development and Economic Growth: Views and Agenda'. A methodological challenge was how to assess the relevant material, judging the quality of the contribution and the validity of the data analysis contained therein. For these reasons, special consideration has been given to factors such as citation history and the reputation of the journal as well as the reputation of the author.

The research relies on numerous previous studies that attempt to explain the role of law in the development of financial markets. These studies include Rioja et al.'s 'Finance and the Sources of Growth at Various Stages of Economic Development', Beck's 'Creating an Efficient Financial System: Challenges in a Global Economy', Beck's et al.'s 'Law and Finance: Why Does Legal Origin Matter?', and La Porta et al.'s seminal work 'Law and Finance'. In determining the relative importance of particular studies, consideration was given to strength of the narrative and analysis contained in them. It was also necessary to identify the limitations of the approaches adopted.

In the context of financial law and regulation, journal articles and Internet sources have been consulted relating to international organisations such as the IMF and the World Bank. These studies are important as they provide up-to-date

information and empirical and quantitative analyses which are adopted, promoted, or implemented by such organisations.

As far as English law is concerned, the study makes reference to major books, such as Black's 'Rules and Regulators', Benjamin's 'Financial Law' and Blair's 'Banking and Financial Services Regulation'. Reference is also made to documents and research provided by the FSA through its website, including the most notable and often-referenced work of Llewellyn, 'The Economic Rationale for Financial Regulation'. In reviewing this type of literature, the contribution of an author was judged by his or her ability to cite relevant key texts from primary sources and to root their work in appropriate theories and concepts.

On the other hand, there is little published research concerning the CML. Apart from an article by Beach, namely 'The Saudi Arabian Capital Market Law: A Practical Study of the Creation of Law in Developing Markets', there is no published work that deals thoroughly with the capital markets regulatory regime in Saudi Arabia. Most extant discussions relate to macro-economic analyses which are presented in works of politics or political economy without any detailed examination of the content of the law or regulations. Nevertheless, these books, such as 'Islamic Law and Legal System: Studies of Saudi Arabia' by Vogel, were of help in developing arguments in the present study as they provide details of the judicial structure in Saudi Arabia. Thus, extensive references to journals, articles, newsletters and business websites are included to substitute for the lack of academic references for Saudi Arabia, in addition to previous works by Saudi nationals in the form of PhD theses.

All secondary sources are fully referenced throughout the text on the basis of the Oxford Standard for Citation of Legal Authorities (OSCOLA).⁹³ Abbreviations for legal journals throughout this thesis are given in accordance with the Cardiff Index of Legal Abbreviations.⁹⁴ Otherwise, the full name of the journal is cited. It must be emphasised that most of the references are secondary, although primary sources of law and regulation are always preferred and given priority over secondary sources whenever each case study country's legal framework is discussed. It is hoped that the weight of referencing does not affect the quality or flow of the arguments presented.

Part IV The Structure of the Thesis

The main inquiry of this thesis concerns whether or not the regulatory regimes established in the UK and Saudi Arabia are effective in providing protection for investors in secondary securities markets through privately enforced regulatory duties. The analysis focuses upon the regulatory doctrines of 'best execution' and 'suitability'.

Chapter two demonstrates the relatively higher importance now ascribed to securities markets. It reviews the literature to show why there is a greater public interest in maintaining the functioning of securities markets in contrast to other markets. Then, the chapter after reviewing different existing definitions of securities markets, attempts to provide a classification of different types of securities markets as

⁹³ Oxford Law Faculty, 'Oxford Standard for Citation Of Legal Authorities' (4th ed., November 2010) <<http://www.law.ox.ac.uk/publications/oscola.php>> accessed 29 June 2011

⁹⁴ Cardiff Index of Legal Abbreviations < <http://www.legalabbrevs.cardiff.ac.uk/>> accessed 29 June 2011

well as a definition for financial assets as the main object of exchanges in securities markets. Critically, the classification suggested includes capital markets with other markets known as ‘securities’. The second chapter then explains the different kinds of such markets; the role of the state in regulating secondary securities markets; justifications of the need for such regulation; and the relationship between securities markets regulation and economic growth. This chapter also deals with one of the purposes of the thesis, which is to assess the general importance of secondary securities markets. The chapter then reviews the current debate as between public enforcement and private enforcement of regulations. While it is argued that private enforcement is a complementary rather a substitute for public enforcement, it is pointed out that within the theory of optimal regulations for secondary securities markets there is an absence of a well-established paradigm for accommodating private enforcement. The chapter concludes with a review of the two key regulatory duties examined in this thesis which are integral to financial intermediation in securities markets in Saudi Arabia and the UK, namely suitability and best execution, describing their historical development, economic importance, and current meaning in the jurisdiction in which they originated, namely the US.

Chapters three and chapter four deal with the UK and Saudi Arabia respectively. Each chapter provides a brief overview of the historical development of the regulatory regimes for securities markets, and demonstrates how regulatory duties are introduced through the regulatory regime as well as how they are privately enforced. Both chapters take into considerations the national political economy and context in which regulatory duties are meant to work. They eventually conclude with the main findings of the thesis and some practical recommendations for improvements as well as recommendations for future research.

Chapter five draws the conclusion of the study and integrates the findings of previous chapters of the comparative analysis. It also provides overall recommendations for both systems which have emerged from the comparative analysis as well as illustrating the difficulties and limitations that were faced in the research and providing some suggestions for future research.

It is important at this stage to define a few key terms that recur throughout the following pages. In this paper, the terms ‘regulation’ and ‘legislation’ are used to distinguish this type of authority from informal governance mechanisms such as norms, religions, codes of conduct and practices provided by organisations. Furthermore, a distinction is made between legislation, which represents the rules and principles introduced by the relevant legislative power in a country,⁹⁵ and regulations which are rules and principles issued by regulatory agencies which, generally speaking in financial law, enjoy rule-making authority. The term ‘legal system’ is not limited to those rules found in statutes and case law; it is the formal legal system which includes the process by which law is made, contested, and ultimately implemented and enforced. The term ‘legal system’ should thus be distinguished from the concept of ‘regulatory regime’. The term ‘private enforcement’ is used to differentiate between the enforcement of the law by public authorities and individuals. Private enforcement refers to ‘individuals or groups whose interests the law or regulation is designed to protect’ and are able to ‘enforce compliance obligations directly against infringers in the civil courts and recover their losses directly’.⁹⁶ In cases where these terms are used differently it will be specified.

⁹⁵ In the UK, it includes primary legislation (Acts of Parliament) and secondary legislation (Statutory Instruments), whereas in Saudi Arabia legislation is introduced by Royal Decree.

⁹⁶ Joanna Gray, ‘Financial Services Act 1986 reforms: Part 2’ (1991) 9 Int. Bank. L. 414

An issue with the concept of ‘retail investor’ is the difficulty in maintaining a consistent definition. There are inconsistencies not only between countries as to the definitions of retail investors, but also among different regulatory agencies within financial markets in one country.⁹⁷ Thus, the issue of the definition of ‘retail investors’ could be seen as regulatory understanding rather than geopolitical differences. This being the case, it is important to identify rationale for the identification of ‘retail investors’ as a distinct class of investors within the regulatory framework examined. Hence, the term ‘retail investor’ in this thesis refers to a member of a class of investors thought to be in need for specific protection by the regulator of secondary capital markets.

Finally, a market oriented system is associated with the private ownership of the means of production, which is compatible with the definitions and models of market economics including those which include extensive state ownership or a hybrid ownership system.

⁹⁷ In countries where there are more than one regulatory agency that deals with certain financial markets, such as the USA, see the US Government Accountability Office, *Financial Regulations: Clearer Goals and Reporting Requirements Could Enhance Efforts by CFT and SEC to Harmonise their Regulatory Approach* (U.S. Government Accountability Office 2010) 22

Chapter Two

The Private Enforcement of Securities Market Regulations

It was noted in the previous chapter that, in relation to its main inquiries concerning investor protection in secondary capital markets, this thesis approaches the subject at two levels. The first adopts a tactic of institutional investigation to give a theoretical framework for the private enforcement of investor protection regulations as perceived to be a matter of ‘between market and state’.⁹⁸ The second is conducted by investigating the scope and appropriateness of the private enforcement of investor protection provisions and their place within the regularity regimes of securities markets in both the United Kingdom and Saudi Arabia.

At the first level of analysis, this chapter undertakes an investigation so as to provide a theoretical framework for the importance of private enforcement of regulations in securities markets. Certainly, the role of private enforcement might be undermined or neglected as a result of the role of public enforcement. However, the necessity implied in claims of the role of public enforcement not only for capital markets regulations, but also securities markets in general, is insufficient in clarifying two critical questions. These are vital in determining, firstly, when and where a private enforcement is most favourable within the chosen institutional design in contrast to public enforcement and secondly, what is the optimal paradigm for effective private enforcement through a regulatory private right of action on the

⁹⁸ Andreas Maurer, ‘Consumer Protection and Social Models of Continental and Anglo-American Contract Law and the Transnational Outlook’ (2007) 14 *Ind. J. Global Legal Studies* 353, 355

grounds of investor protection while also achieving the economic benefits of capital markets.

While it is noted in the previous introductory chapter that this thesis focuses mainly on capital markets in both case studies, current regulatory legal frameworks do not deal specifically with capital markets but approach regulatory problems from the wider perspective of securities markets. Accordingly, the thesis deals with securities markets but with special reference to capital markets as a branch of these markets. Consequently, this chapter develops a general theoretical framework in relation to securities markets from a legal perspective.

Generally, securities regulations aim to enhance the social welfare through increasing the efficient allocation of resources, by either facilitating the distribution of wealth and funds or decreasing the costs of the allocation process.⁹⁹ Because of the reliance on the efficiency of the process, the most common economic justification for securities regulation, as a means of state intervention, is the correction of market failure regarding information identified in these markets.¹⁰⁰

The notion of ‘market failure’ is an economic analysis that presumes that markets should be perfectly efficient.¹⁰¹ For a given market to be considered in or near a state of perfection, three conditions have to be met. Firstly, consumers and producers take decisions that reflect all possible relevant information, and, hence, there is no information asymmetry. Secondly, a price of a product, or a range of products, reflects all costs, including those associated with third parties, social, and

⁹⁹ William Allen, ‘Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis’ (2003) 28 J. Corp. L. 556

¹⁰⁰ Generally speaking, there are a range of policy instruments at the disposal of a government to influence the operation of financial markets: surveillance, ownership and control, guarantees, lending, subsidies, and regulation; OECD (n 32) 15

¹⁰¹ FSA, ‘A Guide to Market Failure Analysis and High Level Cost Benefit Analysis’ November 2006, 5. The publication is available on the FSA website at : <http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf> accessed 29 June 2011

environmental factors. In the event that all these costs are represented in the available price in the market, the market is categorised as having an ‘absence of externality’.¹⁰² Thirdly, suppliers cannot profitably charge prices in excess of fair or reasonable costs.¹⁰³ In other words, there is no market power to control prices in the markets. The notion of market failure is deemed to be of help as a device to facilitate: (1) the analysis of market forces; (2) the detection of deviations from perfect market conditions; and (3) the identification of mechanisms that may correct those deviations.¹⁰⁴

As far as securities markets are concerned, imperfect information among participants and investors is seen as the principal justification for regulations which aim to correct such imperfections through disclosure requirements.¹⁰⁵ Imperfect information results not only in information asymmetry and therefore inefficient allocation, but also permits opportunistic behaviour based on the inequality of the distribution of information. Some such behaviours are deemed so risky as to be likely to threaten the integrity of securities markets and hence to damage investors’ confidence.

While securities markets regulations aim to enhance the social welfare through increasing the efficient allocation of resources, as noted above, these regulations involve costs: both direct, such as compliance costs among participants, and arguably indirect costs, for example, the costs of establishing a regulatory agency. From a legal

¹⁰² Externalities may be positive or negative; they are negative for those on whom they impose costs and positive for those who gain from them. An example of this in financial services is consumer fraud; consumer fraud may have a negative externality in consumption reflected in the costs people incur in defending themselves against it. *Ibid*, 42

¹⁰³ The economic literature usually refers to ‘marginal costs’, which is the saving in a firm’s total cost when output is lowered by a very small unit, and in the long run includes the cost of capital, *Ibid*

¹⁰⁴ For further explanation, see OECD (n 32) 8. But see some criticism of market failure theory as a rationale for regulatory objectives in Harry MacVea, ‘Financial services regulation under the Financial Services Authority: A Reassertion of the Market Failure Thesis?’ (2005) 64 C.L.J. 413

¹⁰⁵ Stiglitz identifies seven types of market failures in financial markets; Stiglitz (n 60); Alan Page and Robert Ferguson, *Investor Protection* (Weidenfeld and Nicolson 1992).

perspective, McCormick points out that an important overlooked area of costs is those associated with the uncertainty of legal rules; his premise is that financial markets, including securities markets, cannot be expected to deliver outcomes in the most efficient manner if the costs and risks associated with contracting are relatively high for both businesses and investors. He suggests that a means to decrease costs is to increase the certainty of legal rules, which is based on the assumption that legal risks increase with the increase in uncertainty of legal rules.¹⁰⁶

Consequently, it could be suggested that an economic view of the economic efficiency of regulations on legal grounds is justified in terms of the reduced risks and costs associated with the decreasing uncertainty arising from transacting. However, regulations should not impose costs through reducing uncertainty to such a level that is more likely to decrease the level of the efficient allocation of resources, which securities markets regulations should aim to increase.

The objective of this chapter, therefore, is to investigate the literature as to the relationship between legal uncertainty, securities markets regulations, exemplified in criteria of the regulatory duties of best execution and suitability, and private enforcement of regulation. The conclusion of this investigation points out that an adequate level of private enforcement within the enforcement framework of securities markets regulatory regimes is more likely to support the effective and efficient regulation of behavioural standards. Having said that, little understanding is available as to when and how, on the one hand, private enforcement enabled by the regulatory regime directly is more likely to be effective combined with public enforcement; and

¹⁰⁶ 'Legal risk tends to arise in the financial markets when there is a misunderstanding as to the law's effect on a transaction or on an entity's financial or commercial position, or when someone's behaviour gives rise to a possibility of legal redress' in Roger McCormick, 'Legal Risk, Law and Justice in a Globalising Financial Market' (2007) 1 Financial Markets Review 283

on the other, where reliance on public enforcement is the best choice within securities markets.

It should be emphasised at the outset that the argument advanced here has two main limitations. Firstly, it focuses only on the role of private enforcement in deterring, detecting, and correcting socially harmful violations of the law, rather than on the private compensatory purpose that private rights of action also sometimes serve.¹⁰⁷ While the two functions are often interrelated, in some cases being impossible to separate, the argument developed here considers the deterrent function and so would not necessarily apply directly to private remedies with primarily compensatory purposes.¹⁰⁸ For the same reason, the argument does not consider views based on the grounds of distributive justice, which would require a remedy to rectify a contract where there is apparent inequality between parties or the circumstances around it that makes it unfair to one of the parties.¹⁰⁹

The second limitation on the scope of the investigation is that it focuses exclusively on private enforcement of securities markets regulations in which a private plaintiff sues to compel a private defendant to comply with the regulatory regime, make restitution, and perhaps pay damages or civil fines. The analysis, therefore, does not consider actions by private parties against the regulatory agency

¹⁰⁷ Pamela Bucy, 'Private Justice' (2002) 76 S. Cal. L. Rev. 15–17, cited in Matthew Stephenson, 'Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies' (2005) 91 Va. L. Rev. 93, at footnote 6

¹⁰⁸ Stephenson, *Ibid*, 97

¹⁰⁹ See Michael Trebilcock, 'Winners and Losers in the Modern Regulatory System: Must the Consumer always Lose' (1975) 13 Osgoode Hall. 619, 624; Iain Ramsay, 'Consumer Credit Law, Distributive Justice and the Welfare State' (1995) 15 OJLS 177. Distributive justice should be distinguished from corrective justice. The latter specifies that where there is a breach of a specific legal wrong there is a remedy to rectify it. Distributive justice, on the other hand, is concerned with the idea of distributing resources (including rights) on the basis of what is fair

which they claim has neglected some nondiscretionary legal duty or inappropriately performed such discretion.¹¹⁰

It is also important to add some preliminary remarks regarding the scope of the investigation and the analysis. First, it is assumed that courts will carry out the adjudication of legal disputes. While the issue of alternative adjudication methods, such as arbitration and ombudsmen, are extremely interesting from an economic standpoint, it exceeds the scope of this comparative thesis. Second, this chapter does not cover the economics of legal harmonization among countries or legal families. An argument invoked by supporters of private enforcement of laws in the European context could be that it better lends itself to harmonization because it does not require states to adjust their public enforcement apparatus.¹¹¹ Such arguments would require an assessment of the advantages and disadvantages of legal harmonization within the EU project,¹¹² but also, since the EU project does not provide the direct right of action as a means of redress among member countries,¹¹³ this subject including the EU initiatives were left out of the argument.

Accordingly, this chapter is divided into three parts. Part I illustrates the social welfare policy behind securities regulations by pointing out the economic importance of regulations for securities markets in general and capital markets in particular. It starts by attempting to provide a definition of securities markets as well as the kinds of securities markets that are included within the scope of the thesis, namely those for shares and bonds. It also examines the extent of the role of regulations in securities markets with the objective to clarify what regulations are meant to achieve. It reviews

¹¹⁰ Lars Klöhn, 'Private Versus Public Enforcement of Laws - A Law & Economics Perspective' (December 23, 2010) <<http://ssrn.com/abstract=1730308>> accessed 29 June 2011

¹¹¹ Gerhard Wagner, 'The Economics of Harmonisation: The Case of Contract Law' (2003) 39 *Common Market L. Rev.* 995

¹¹² Klöhn (n 110)

¹¹³ Niamh Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge 2010) 444-447

the relevant literature to demonstrate the importance of securities markets and the role of regulation in enhancing the economic benefits expected from them.

Part II demonstrates the importance of private enforcement of regulations for an effective and efficient regime imposing business conduct regulations in securities markets. It provides, firstly, a historical background regarding the development of private enforcement in securities regulations in the U.S.; and, secondly, lays out the advantages and disadvantages of using private rights of action to enforce substantive regulatory protection. The analysis in this part makes clear that an assessment of the net social benefits of private enforcement entails complex, contingent, and context-specific policy judgments.

Part III provides an investigation of the literature into the importance of the investor protection substantive regulatory duties, namely the regulatory duties of suitability and best execution, and their effects on the efficiency function of securities markets. It points out the importance of stockbrokers for the functioning of securities markets as well as the IOSCO general principles for the protection of investors in secondary capital markets. It examines the evolution of both best execution and suitability towards being recognised as regulatory duties, as well as their importance as part of the role of securities markets in enhancing the allocation of resources

Part IV gives the conclusions of the analysis provided throughout this chapter.

Part I The Importance of Securities Markets Regulations

A) Definition of Securities Markets

Financial activities have enjoyed rapid expansion around the world in recent decades thanks to de-regulation initiatives combined with advances in information and

communications technologies. Currently, financial activities vary in both scope and level and the nature of participation in comparison to the historical development of these markets. The demand side of financial markets, for example, includes state finance, corporate finance, and individual finance. Finance is sought to enhance various specific activities (consumption, production, risk transfer, insurance, hedging, investment and acquisition), and those different needs are met by different agents (banks, insurance companies, foreign investors, leasing companies) in different markets (banking, stock markets, insurance, derivatives).¹¹⁴

This rapid expansion of financial activities raises a number of difficult issues in determining the precise extent of securities markets.¹¹⁵ Traditionally, the boundaries dividing instruments and markets were drawn within the different classes of intermediaries. Banks specialized in short or medium/long term maturities, functional/commercial operations, deposits and investments; and financial intermediaries handled broker-dealer negotiations, asset management and advisory functions within stock or equity markets; whereas insurance companies dealt in life and other insurance policies.¹¹⁶ However, as a result of the deregulation initiatives in the 1980s, this model of the segmentation of financial markets now fails to match participants' involvement in different segments as intermediaries, who consequently become involved with various instruments and segments of financial markets that cut across traditional boundaries. The term 'financial markets' is not restricted to insurance, banking and brokerage services; there are different markets that are categorised as financial markets, but nonetheless cannot be included under the three

¹¹⁴ Michael Knoll, 'The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage' (2004) 87 Oregon Law Review 1, 93

¹¹⁵ Gerogio Di Giorgio, Carmine Di Noia and Laura Piatti, 'Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area' (2000) Wharton Financial Institutions Center Working Paper, No. 24-B, 4 <<http://fic.wharton.upenn.edu/fic/papers/00/0024.pdf>> accessed 29 June 2011

¹¹⁶ Ibid

traditional segments. Walker and Blair, for example, assert that the term financial markets consists of: credit markets (banks and bonds markets), commodity markets, money markets, derivatives markets, insurance markets, the gold market, stock markets and foreign exchange markets.¹¹⁷

Even the list of markets suggested by Walker and Blair does not spell out the various sub-markets. For example, under commodity markets there is an oil market, cotton market, potato market, and so on. For each market there are different derivatives markets (options, futures, spot and forward), and some derivatives markets include on-exchange markets (where transactions are executed through an official exchange) and off-exchange markets (with transactions executed among the parties themselves).

As far as securities markets are concerned, it is difficult to identify a comprehensive definition of ‘securities markets’, since the term ‘securities’ is employed differently in the literature depending on the perception of a particular author as to which instruments the terms implies. For example, the Bank of International Settlement (henceforth BIS)¹¹⁸ perceives the term securities to include both international and domestic debt and equity instruments, but excludes other forms of securities.¹¹⁹ In a similar vein, the term ‘securities’ is used by Hudson, a well-known scholar in financial law in the UK, to include shares (ordinary shares, preference shares and treasury shares), bonds, derivatives, and mortgages.¹²⁰ For the same reason, one must be cautious when referring to the American literature, since the sense of the term ‘securities’ there varies widely, which could be attributed to the

¹¹⁷ Michael Blair and Gorge Walker, *Financial Markets and Exchanges Law* (OUP 2007) 17-18

¹¹⁸ BIS describes itself as ‘an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks’. More information available on their website at <<http://www.bis.org/>> accessed 29 June 2011

¹¹⁹ <<http://www.bis.org/statistics/secstats.htm>> accessed 29 June 2011

¹²⁰ Alastair Hudson, *The Law of Finance* (Sweet & Maxwell 2009) 909

contrasting definitions provided in a range of legislations and regulations dealing with securities markets.¹²¹

Consequently, disagreements in relation to definitions dictate a need to be explicit about exactly what is meant by the term securities markets throughout the thesis. To this end, it is deemed insufficient to attach the word ‘market’ to certain kinds of financial contracts, transactions, or activities, but rather to investigate what the meaning of ‘markets’ is and why they exist in order to specify what is necessary for a market to be recognised as such.

Generally, a market is considered to be ‘any identifiable location, system or other set of formalised relations through which any commodity or product may be bought and sold’.¹²² Essentially, markets are perceived to exist because they improve the production of the products exchanged by increasing the specialisation in trade – or the ‘division in labour’ as proposed by Adam Smith.¹²³ Specialisation facilitated by the exchange process, whereby scarce resources are channelled to various sectors of the economy, will eventually increase the welfare of a society.¹²⁴

Subsequently, it is a question as to what is being exchanged in financial markets in general and securities markets in particular. While it is suggested that what is taking place in such market is the exchange of financial assets,¹²⁵ this does not clarify how financial assets would benefit from specialisation based on the exchange

¹²¹ See for example, Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (Aspen 2003) 231; Edward Green and others, *U.S. Regulation of the International Securities and Derivatives Markets: Volume 1* (9ed, Aspen Publication 2006) 14-42, 14-59; and Jeffrey Beatty and Susan Samuelson, *Introduction to Business Law* (South-Western Cengage Learning 2010) 361

¹²² Blair and Walker (n 117) 19

¹²³ In his seminal work *An Inquiry Into the Nature and Causes of the Wealth of Nations* (1776) (Arlington House 1965), chapter III. For a recent survey for economic analysis on the subject, see James Buchanan, ‘Let Us Understand Adam Smith’ (2008) 30 *Journal of the History of Economic Thought* 21, 23

¹²⁴ Smith, *ibid*. Further details as to the implication of this assumption in financial markets is available in B. G. Pettet, John Lowry and Arad Reisberg, *Pettet’s Company Law: Company and Capital Markets Law* (Pearson Longman 2009) 353

¹²⁵ Clifford Gomiz, *Financial Markets Institutions And Financial Services*, (New Delhi, Prentice-Hall, 2008) where he states that financial markets are ‘... a place in which financial assets are created or transferred’, 8

process. A better understanding, thus, can be achieved if the term financial asset is defined.

Ridley's concise definition of financial assets describes them as contracts, claims, or transactions which represent a process where 'money passes in one direction, in exchange for some right, ... typically consisting, for example, of an obligation to pay, repay or share in profits; or contingent rights in the form of options, general life insurance, sickness pay, pensions, and so on'.¹²⁶

Such a definition of financial assets helps in emphasising the importance of law in the functioning of financial markets. To start with, financial assets are mere claims and obligations and hence are evidently intangible. Given that they involve intangible claims and obligations, it is argued that a key feature of all financial instruments is thus the presumption that 'they are based on legally enforceable contracts', of a promise or an obligation.¹²⁷ It is for this reason that it is argued that financial assets are '...creatures of the law and without an effective legal infrastructure they have no value'.¹²⁸ Therefore, a financial market can be defined as any organised process in identifiable locations or systems through which financial contracts, claims or transactions that represent money are exchanged, issued and traded for an obligation or a right.

That being the case, one can find three elements in a financial asset which are essential for them to be considered as securities. Firstly, they are instruments that represent financial claims; secondly, they have their own value in cash terms; and, thirdly, they are freely transferable.¹²⁹ In retrospect, these three essential elements do

¹²⁶ Emphasis added. Adam Ridley, 'Priorities in International Financial Regulation' in Philip Booth and David Currie (eds), *The Regulation of Financial Market* (Institute of Economic Affairs 2003) 145

¹²⁷ Ibid

¹²⁸ McCormick (n 106)

¹²⁹ Moorad Choudhry and others, *Capital Market Instruments: Analysis and Valuation* (Financial Times Prentice Hall 2001) 6; Alastair Hudson, *Securities Law* (Sweet & Maxwell 2008) para 1-23

not contradict the definition of a financial market suggested previously, that is, a market for financial contracts, claims or transactions that represent money exchanged, issued and traded for an obligation or a right.¹³⁰ It is, however, more specific in that they are transferable and have their own value.

Consequently, it is possible to suggest that a securities market is any organised process in an identifiable location or system through which financial contracts or claims which represent an obligation or right that have their own value and are transferable are exchanged, issued and traded.

B) The Importance of Securities Markets

Joseph Stiglitz, a Nobel prize recipient in economics well-known for his critical view of the management of globalization and free-markets, once described financial markets as ‘the brain of the entire economic system, the central locus of decision making’. He added that ‘if [financial markets] fail the performance of the entire economic system may be impaired’.¹³¹

The vital role of financial markets is deemed to arise from the help that these markets provide in increasing the accumulation of savings within a country and transferring these savings to wealth-enhancing investment projects.¹³² Financial markets execute their functions through both distributing and providing liquidity and credit efficiently to agents in the wider economy.¹³³ Both credit and liquidity are essential not only for the production of goods and services, but also to allow the desire to consume these goods and services to take effect.¹³⁴ In addition, financial

¹³⁰ See chapter Two, Part I (b)

¹³¹ Stiglitz (n 60)

¹³² Walter Bagehot, *Lombard Street: A Description of the Money Market*, (1873), (Orion Editions 1991); Khan (n 21)

¹³³ Hendrik Houthakker and Peter Williamson, *The Economic of Financial Markets* (OUP 2004) 284

¹³⁴ Ibid

markets are supposed to help in adjusting any imbalances between the supply and demand sides within an economy; financial markets should be able to provide a self-regulating mechanism that leads, more or less on its own, to its own stability.¹³⁵ While it has become, to say the least, unfashionable to insist on the self-correcting character of financial markets after the 2007 crisis,¹³⁶ they are nonetheless the principal means to implement any decision concerning the adjustment of credit and liquidity.

In addition to their influence on credit and liquidity, Levine demonstrates that financial markets provide five services which enhance efficiency, increase productivity and reduce the costs to agents in the economy in addition to their role in increasing savings and the distribution of credit and liquidity.¹³⁷ Those services are: 1) risk management;¹³⁸ (2) screening;¹³⁹ (3) providing information for the prices of events, risks and assets; (4) facilitating transactions, and (5) managing the behaviour of managements.¹⁴⁰

Having said that, both the importance and role of financial markets have arguably increased with the spread of market oriented economic policies as the

¹³⁵ Sebastian Dullien and Christian Kellermann, 'Good Capitalism... and what would need to change for that' (2010) 4 Social Europe Journal 26

¹³⁶ The financial crisis of 2007 left little support for the ability of financial markets to adjust themselves. Alan Greenspan, a veteran supporter of deregulation and the liberation of financial markets, admitted that he had put too much faith in the self-correcting power of free markets, see Edmund Anderws, 'Greenspan Concedes Error on Regulation' *New York Times* (New York, 23 August 2008 < <http://www.nytimes.com/2008/10/24/business/economy/24panel.html>> accessed 29 June 2011

¹³⁷ Ibid

¹³⁸ This service is easily illustrated by the insurance market but is not confined to it. For example, Stiglitz suggests that the real importance of stock market is its function of transferring risks rather than raising capitals (n 60). Furthermore, sophisticated securities markets have developed new tools, for details see Peter Spencer, *The Structure and Regulation of Financial Markets* (OUP 2002) 75; Peter Haiss and Ljell Sümegi, 'The Relationship Between Insurance and Economic Growth in Europe: A Theoretical and Empirical Analysis' (2008) 35 *Empirica* 405

¹³⁹ It is argued that in a developed financial system, financial institutions play a major role in fostering innovation not only through providing capital, but also choosing those projects which have better returns; Giancarlo Bertocco, 'Finance and development: Is Schumpeter's analysis still relevant?' (2008) 32 *Journal of Banking & Finance* 1174

¹⁴⁰ Ross Levine, 'Financial Functions, Institutions, and Growth' a chapter in Alison Harwood and Bruce L. R. Smith (eds), *Sequencing? Financial Strategies for Developing Countries* (Brookings Institution Press 1997)

optimal economic structure throughout the world.¹⁴¹ Since the collapse of the Soviet Union and communism as an economic ideology, state control over the economy has been considered inappropriate, not only among previous communist countries¹⁴² but also less developed countries which had previously been dominated by the role of the public sector in providing services and the ownership of productive resources.¹⁴³ Currently, the market economy structure is still the default economic model in the world; for example, membership of the World Trade Organisation (henceforth WTO) requires adopting a policy based on the market economy orientation.

Consequently, it is of great importance at this time to clarify the importance of financial markets in general, and securities markets in particular, for understanding market oriented policies and the transformation of an economy towards such policies.

Notwithstanding the existence of different forms of market economy,¹⁴⁴ they share a core concept of minimising the influence of non-economic factors that could influence the allocation of resources through market forces.¹⁴⁵ To that end, the pricing mechanisms provided by markets are assumed to be the best available means to channel goods and services to their most highly valued use in the most efficient way.

¹⁴¹ Statistically, there has been evidence to support the notion that policies in accordance with the market economy model are a step towards both economic development and modernisation; see Felix Rioja and Neven Valev, 'Finance and the Sources of Growth at Various Stages of Economic Development' (2004) 42 *Economic Inquiry* 127; Ross Levine, 'Finance and Growth: Theory and Evidence' (2004) NBER Working Paper, Paper No. W10766/2004 <<http://www.nber.org/papers/w10766>> accessed 29 June 2011

¹⁴² Phillip Arestis and Panicos Demetriades, 'Financial Development and Economic Growth: Assessing the Evidence' (1997) 107 *The Economic Journal* 783; Wendy Carlina and Collin Mayer, 'Finance, Investment, and Growth' (2003) 69 *Journal of Financial Economics* 191

¹⁴³ The unsatisfactory results of other social models have encouraged developing countries to seek alternative models. See Said El-Naggar, 'Privatization and Structural Adjustment: The Basic Issues' in Said El-Naggar (ed), *Privatization and Structural Adjustment in the Arab Countries* (IMF 1989); Ron Dore, 'Stock Market Capitalism and its Diffusion' (2002) 7 *New Political Economy* 115

¹⁴⁴ For example, there is the Anglo-Saxon, the German and the Japanese models. For further discussion see Dore, *ibid*

¹⁴⁵ Hans Blommestein and Michael Spencer, 'The Role of Financial Institutions in the Transition to a Market Economy' in Gerard Caprio, David Folkerts-Landau and Timothy David Lane (eds), *Building Sound Finance in Emerging Market Economies*, (IMF and World Bank 1994) 143

Stout captures the relations between price, efficiency and increased prosperity, noting that:

‘A free market relies on a willingness to pay, as measured in monetary terms, to determine how highly individual consumers value particular goods. A good is presumed to be worth most to the consumer who will pay the highest price for it. Market distortions may shift price from the equilibrium that would be set by supply and demand in a perfect market. Whether these distortions are the result of price controls (such as minimum wage laws), monopoly, or the slow incorporation of information concerning value, they are assumed to produce sub-optimal allocations of resources. These diminish the total wealth available to be distributed and reduce social welfare’.¹⁴⁶

Thus, it can be argued that a competitive private sector should be able to both gather savings at a market rate of interest and allocate capital to the most efficient private sector projects,¹⁴⁷ given that allocative decisions are rationed by price and borrower insolvency.¹⁴⁸ It is therefore plausible to suggest that the most important aspect of financial markets in a market economy model is the process of price discovery for the provision of credit and payment of interest.

In addition to the pricing of credit and liquidity, financial markets are also used increasingly as a means to transfer the ownership of resources not only from states to the private sector, but also between agents in the private sector itself. This is

¹⁴⁶ Lynn Stout, ‘The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation’ (1988) 87 Mich. L. Rev. 613, at footnote 155

¹⁴⁷ Mohamed A. El-Erian and Sgamsuddin Tareq, ‘Economic Reform in the Arab Countries: A Review of Structural Issues’ in Said El-Naggar (ed), *Economic Development of the Arab Countries: Selected Issues* (International Monetary Fund 1993) 33

¹⁴⁸ Blommestein and Spencer (n 145)

done mostly through an initial public offer of state owned enterprise or raising capital by companies and private agents.¹⁴⁹

It should be noted that any careful investigation of the function of stock markets must distinguish between two types of markets: (i) primary markets in which the securities are issued and offered to the public and where privatisation is taking place, and (ii) secondary markets in which those securities are traded among investors, which is the main focus of this thesis.¹⁵⁰

The primary markets are these where newly issued securities are sold to investors, whether national or international. The proceeds generated from the primary market go from subscribers to the organizations that issued the securities.¹⁵¹ Thus, it is reasonable to maintain that these markets cause savings and wealth to move from savers to producers, therefore yielding economic rewards.

However, the economic benefits of secondary capital markets are not as clearly straightforward as those in primary markets. Critically, exchanges in secondary markets do not move savings or wealth to producers or wealth enhancing projects. Secondary markets are those where sellers of existing securities meet buyers to exchange ownership only, and thus no new securities are created.¹⁵² One question that needs to be asked, consequently, is whether or not there are economic benefits from secondary markets given their abstention from the process of the allocation of resources between producers and savers ascribed to financial markets in general and primary securities markets in particular.

It could be argued that the vital role of secondary securities markets is considered to be their support for primary markets. It is evident that a liquid

¹⁴⁹ Bernardo Bortolotti and Domenico Siniscalco, *The Challenges of Privatization: An International Analysis* (OUP 2004) 59

¹⁵⁰ Hudson, *Securities Law* (n 129) paras 1-36, 1-37

¹⁵¹ David Coates, *Models of Capitalism: Debating Strengths and Weaknesses* (Edward Elgar 2002) 242

¹⁵² *Ibid*

secondary market for shares or securities encourages the involvement of citizens in the primary market and ensures the efficient distribution of ownership after a privatisation programme.¹⁵³ Secondary markets do so by raising the confidence of savers and investors to subscribe in a primary offering, through providing a means to transfer risk and available liquidity pursuant to the subscription process.¹⁵⁴ It is claimed that, by offering subscribers to securities a forum for exchange, secondary markets effectively supply subscribers in primary markets with the opportunity to ‘alter their investment horizon’.¹⁵⁵ To that end, it is claimed that it is the high level of liquidity which permits buyers and sellers to transact quickly and without substantial changes in price, which increases confidence in the financial instruments.¹⁵⁶ Bernstein notes that, ‘paradoxical as it may seem, the easier the exit from ownership of a corporation, the more attractive its ownership becomes’.¹⁵⁷ Therefore, it could be argued that the principal function of secondary securities markets is to increase the confidence in securities offered to investors through the availability of a means to transform long-term investment into liquid funds.

In addition to supporting primary markets, it has been argued that effective secondary securities markets increase the wealth within the economy by reducing the price of credit through the provision of liquidity. A large volume of published studies describing the role of secondary capital markets, namely for stock, has emphasised the important function of liquidity in increasing efficiency by reducing the costs of

¹⁵³ Bernardo Bortolotti and others, ‘Privatization and Stock Market Liquidity’ (2007) 31 *Journal of Banking and Finance* 297

¹⁵⁴ Blommestein and Spencer (n 145) 154. For the secondary market for bonds, see Katinka Barysch, Heinemann Friedrich and Max Steiger, ‘Bonds Markets in Advanced Transition: A Synopsis of the Visegrád Bond Markets’ ch. in Ronald MacDonald and Rod Cross (eds), *Central Europe Towards Monetary Union: Macroeconomic Underpinnings and Financial Reputation* (Kluwer 2000)

¹⁵⁵ David Coates, *Models of Capitalism: Debating Strengths and Weaknesses* (Edward Elgar 2002) 242

¹⁵⁶ *Ibid*

¹⁵⁷ Peter Bernstein, ‘Liquidity, Stock Markets and Market Makers’ (1987) 16 *Financial Management* 54, 55

capital.¹⁵⁸ By reducing the volatility in prices of stocks and other securities, these financial instruments become marketable and easy to transfer;¹⁵⁹ eventually facilitating the usage of those securities as collateral which in turn generates additional capital in an economy.¹⁶⁰

Interestingly, the role of secondary markets is far clearer with regards to the role of financial markets in generating information about the price of risks, assets, management or events as pointed out by Levine. This price information generated by secondary securities markets is asserted to work as a guide to decisions about the allocation of capital within an economy.¹⁶¹ For instance, it helps to assess management performance, gives indications of the pricing of new issues in the primary market and reflects the cost of capital within an economy.¹⁶²

In short, it is thus reasonable to suggest that secondary securities markets are able to enhance the social welfare not only in transferring the ownerships of productive resources to the private sector within a market economy, but also in supporting economic growth and wealth creation. Given their economic importance and size, it could be argued that there is a public interest in maintaining the efficient functioning of secondary securities markets. Having said that, it should be emphasised that modern securities markets are extremely complex and vary widely in the substantive securities traded in them, and the next section attempts to provide an understanding of the different kinds of these markets.

¹⁵⁸ For example, a study by Levine shows that market liquidity – the ability to buy and sell securities easily - exhibits a stronger connection to long term growth; see Levine (n 15)

¹⁵⁹ Richard Teweles and Edward Bradley, *The Stock Market* (7th ed, Wiley 1998) 102

¹⁶⁰ Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Black Swan 2001)

¹⁶¹ Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth, and Instability' (2000) 28 *World Development* 1075, 1079

¹⁶² Richard Herring and Anthony Santomero, 'What Is Optimal Financial Regulation' ch. in Benton Gup (ed), *The New Financial Architecture: Banking Regulation in the 21st Century* (Quorum 2000)

C) Types of Securities Markets

The definition provided in the proceeding discussion permits the inclusion of different kinds of financial instruments that have been developed in modern markets. For clarity, securities markets can generally be grouped into three categories: capital markets, derivatives markets and money markets.¹⁶³ A brief explanation of each group is deemed essential to avoid any confusion in the following analysis and discussion, since the main inquiry of this thesis focuses on capital markets but excludes derivatives and money markets.

The term 'money markets' includes those dealing in securities representing short-term debt which matures within one year.¹⁶⁴ Examples of money markets trading in such instruments are: treasury bills (or T-bills) markets, interbank markets, certified deposit markets, inter-corporate depository markets, commercial bill markets and repo markets.¹⁶⁵ A well functioning and developed money market trades to provide mechanisms for liquidating commercial papers, such as discounting bills of exchange. It also provides instant access to funds needed urgently by financial institutions such as banks, as well as helping governments in short term financial need through treasury bills. Additionally, money markets are one of the means available to central banks to execute monetary policies, including the maintenance of a moderate level of inflation.¹⁶⁶

Capital markets, on the other hand, exchange securities that represent ownership or debt with maturity dates of over one year. Capital markets are thus

¹⁶³ Jae Shim and Michael Constas, *Encyclopedic Dictionary of International Finance and Banking* (St. Lucie Press 2001) 103

¹⁶⁴ Ibid

¹⁶⁵ Repo stands for ready forward contract. It is a contract where a seller sells and repurchases the same securities at a mutually decided future date and price. For more information see Moorad Choudhry, *The REPO Handbook* (Elsevier 2002) 3

¹⁶⁶ For more elaborate analysis, see Jens Forssbaeck and Lars Oxelheim, *Money Markets and Politics: A Study of European Financial Integration and Monetary Policy Options* (Edward Elgar 2003) ch. 3

classified into debt and equity markets depending on the nature of the legal right embodied in the instrument.

In debt capital markets, participants exchange financial instruments that have a fixed income claim with a maturity date of more than one year. Holders of debt instruments expect to receive from the issuer of the instrument interest on the loan at regular fixed times and, by the maturity date, the full amount of the loan.¹⁶⁷ The holder's rights to interest and repayment of the principal amount are secured against the assets of the issuer.¹⁶⁸ Well-known examples of debt instruments are treasury bonds, municipal bonds, corporate bonds, convertible bonds and mortgage-backed bonds.

In contrast to debt markets, equity markets deal with instruments that represent rights of ownership.¹⁶⁹ A claim of ownership entitles the holder, *inter alia*, to receive from the issuer two sources of future cash: first, the right to a regular dividend payment, and second, the right to a portion of the company once it is sold or liquidated.¹⁷⁰ Examples of equities are preferred stocks and common stocks.

Derivatives markets are more complex because of the nature of the financial claims exchanged. Derivatives are contracts whose values are "based on other underlying assets such as stocks, currencies, interest rates or commodities".¹⁷¹ There are three criteria for categorising derivatives: the nature of the obligation (future, option or swap), the underlying assets (share, bond, or mortgage), and trading style (on-exchange traded or off-exchange bespoke 'over the counter' or OTC).¹⁷²

¹⁶⁷ There are different kinds of bonds and repayments of the principal amounts by instalments or at specific dates during the life of the instrument.

¹⁶⁸ Hudson, *The Law of Finance* (n 120) 912

¹⁶⁹ *Ibid*

¹⁷⁰ Neil Johnson, Paul Jefferies and Pak Ming Hui, *Financial Market Complexity* (OUP 2003) 6

¹⁷¹ Pratap Subramanyam, *Investment Banking: Concepts, Analyses and Cases* (Tata McGraw-Hill 2008) 14

¹⁷² Errol Dansieger, 'Derivative Risk- OTC and ETD' ch. in Dennis Cox (ed), *Frontiers of Risk Management: Key Issues and Solutions* (Euromoney Books 2007) 78-81. See also Appendix 2 of the

Accordingly, derivatives that are considered to fall within the scope of capital markets are those whose underlying assets are an instrument in capital markets.¹⁷³

Methodology dictates that the discussion in this thesis is restricted to capital markets, particularly those for common shares and bonds and their derivatives. It is thought that, since the study is comparative in nature and aims to examine the effectiveness and efficiency of certain regulatory rules across two jurisdictions, it is necessary to restrict the inquiry to those markets that exist in the U.K. and Saudi Arabia. While the U.K. possesses almost all kinds of securities markets, Saudi Arabia has only capital markets consisting of a common shares market and a recently developed Islamic bond market (Sukuk) as well as a narrow OTC derivatives markets.¹⁷⁴ Accordingly, the following discussion focuses mainly on secondary capital markets and the next section demonstrates the importance of securities markets regulations with special references to secondary capital markets.

D) Rationale for Securities Markets Regulations

Some have suggested that, historically, the state's attempts to intervene in and regulate secondary securities markets can be traced back to a Statute of Edward I in England in 1285, when brokers who worked as agents were required to take an oath of good behaviour.¹⁷⁵ Others suggest that the more appropriate event was the Bubble Act in the seventeenth century.¹⁷⁶ Notwithstanding the differences as to the beginning

Memorandum by the Futures and Options Association (FOA) (2010) a response to the paper 'The Future Regulation of Derivatives Markets: Is the EU on the Right Track?' European Union Committee, <<http://www.publications.parliament.uk/pa/ld200910/ldselect/ldcom/93/93we13.htm>> accessed 29 June 2011

¹⁷³ Pratap Subramanyam, *Investment Banking: Concepts, Analyses and Cases* (Tata McGraw-Hill 2008) 14

¹⁷⁴ Oxford Business Group, *The Report: Saudi Arabia 2008*, (OUP 2008) 80. For more historical analysis, see chapter Four Part I (c) of the present study.

¹⁷⁵ Pettet, Lowry and Reisberg (n 124) 343

¹⁷⁶ Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots (1690-1860)* (CUP 2002) 41-88

of state intervention, it is accepted that modern securities regulation as a sophisticated and comprehensive system of law first emerged in the U.S. in the 1930s.

As far as primary securities markets are concerned, it was with the passing of the Securities Act 1933 first regulated the public offerings of securities.¹⁷⁷ In the following year, the Securities and Exchange Act 1934 was passed to regulate secondary markets and also established the Securities and Exchange Commission (henceforth SEC) as a regulator of securities markets, brokers, dealers, and other matters. Since then, it has become a matter of public and general interest that securities markets should function properly, based on the belief that part of the cause of the Great Depression in the US resulted from their collapse.¹⁷⁸

Currently, it is hardly disputed that the state has a role in regulating securities markets as well as instituting regulatory agencies to deal with them, to the extent that state intervention itself is considered as best practice by international organisations.¹⁷⁹ The principal justification for regulations as far as secondary securities markets are concerned is to protect investors and maintain their confidence.¹⁸⁰ It was noted in the Introduction chapter that empirical researches suggests a positive correlation between the strength of capital markets and the higher priority accorded to protecting investors against unacceptable behaviour in securities markets. In this case, it is necessary to ask if strengthening securities markets law by introducing regulations against unacceptable behaviour is a sufficient justification to introduce regulations and, if so, why.

¹⁷⁷ Ibid 345

¹⁷⁸ Thomas McGraw, *Prophets of Regulations: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn* (Belknap Press of Harvard University press 1984)153-209; BME Research Department, 'Close To the Investor' (2009) Focus, World Federation of Exchanges, 3, <<http://www.world-exchanges.org/files/focus/pdf/focus%201109.pdf>> accessed 29 June 2011

¹⁷⁹ Some disagreement exists, see, for instance, Edward Strigham, Peter Boettke and J.R. Clark, 'Are Regulations the Answer for Emerging Stock Markets? Evidence from the Czech Republic and Poland' (2008) 48 *The Quarterly Review of Economics and Finance* 541

¹⁸⁰ Amir Litch, 'International Diversity in Securities Regulation: Roadblocks on the Way to Convergence' (1998) 20 *Cardozo L. Rev.* 227, 245

The premise of securities regulations is that mandatory disclosure combined with anti-fraud liability and the regulation of securities intermediaries will permit securities investors and their advisors to have the information necessary to move capital to its optimal use.¹⁸¹ In other words the protection of investors is a means to achieve healthy capital markets. Such a claim is based on the conclusion that securities markets involve major difficulties that market forces find burdensome or impossible to overcome on their own.

Initially, investors are unable to be sure of the quality of assets exchanged in the markets. Lacking the resources to gain access to information or to analyse information provided in different forms, investors may thus act irrationally and make poor investment choices.¹⁸² In the absence of regulation there is no incentive for those holding information, such as managements and issuers of shares, to share it with other participants, and it is meanwhile economically unjustifiable to force all participants to work to obtain it.¹⁸³ Consequently, it is believed that regulation which imposes periodical disclosure requirements helps in redistributing information among participants in securities markets, and hence allowing investors to make informed decisions.¹⁸⁴

In addition to judging the quality of assets, the Securities and Exchange Act 1934 is claimed to have been introduced to provide two primary benefits for investors through disclosure: firstly, determining the quality of the assets which should be reflected correctly in the price, and; secondly, to 'prevent some fraudulent transactions that cannot stand the light of publicity'.¹⁸⁵

¹⁸¹ Ibid

¹⁸² Stephen Choi and Andrew Guzman, 'Portable Reciprocity: Rethinking the International Reach of Securities Regulation' (1998) 71 S. Cal. L. Rev. 903, 924

¹⁸³ Hudson, *The Law of Finance* (n 120) 944

¹⁸⁴ Ibid

¹⁸⁵ Loss and Seligman (n 121) 37

Conceptually, it could be suggested that the disclosure requirements that aim to protect investors are based on the informational disadvantages of investors against issuers of securities. Investors might be subject to sharp practices by professionals with access to greater information and resources who are willing to take advantage of it. Different regulatory techniques are recognised as essential, among which are periodic disclosure, standardising disclosure and the external auditing of companies' financial statements.

Moreover, certain acts based on informational advantages are prohibited in securities regulations.¹⁸⁶ Insider dealing regulations, for example, are introduced to prohibit corporate officials and owners with information about the financial prospects of their companies to profit at the expense of non-insiders. Defrauding investors by leading them to subscribe or purchase securities in bogus companies was a common practice that led to the development of the concept of the suitability of advice in the US.¹⁸⁷ Such importance ascribed to the disclosure and informational disadvantage of investors is supported by research that shows that the priority accorded to investor protection against unacceptable behaviour correlate positively with the strength of capital markets.¹⁸⁸

It should be emphasised that there are other investor protection measures deemed necessary which, nonetheless, are not based on informational advantages. These measures are fundamentally based on the notion that regulations should protect investors against 'excessive prices or opportunistic behaviour by providers of financial services'.¹⁸⁹ Takeover rules and the protection of minority shareholders are based on

¹⁸⁶ Franklin Allen and Richard Herring, 'Banking Regulation Versus Securities Market Regulation' (2001) The Wharton Financial Institutions Center, Working Paper No.01-29, 23 <<http://escal.free.fr/docs/finance/bankingregulation.pdf>> accessed 29 June 2011

¹⁸⁷ See Part IV of this chapter

¹⁸⁸ See chapter One, Part II for more discussion.

¹⁸⁹ Allen and Herring (n 186) 10-11

the notion that minority shareholders should not be exploited by majority shareholders.¹⁹⁰

Therefore, it could be claimed that regulation in secondary markets is justified to ensure a level of quality of protection provided to investors.¹⁹¹ An important regulatory technique to ensure this level, in addition to disclosure, is for the regulatory regime to establish and publish a minimum level of accepted standards of conduct that are binding for the participants in services in securities markets.

Another rationale for securities regulations is the reduction of systemic risk in these markets. In general, a systemic risk in financial markets refers to the risk of an event which ‘will trigger a loss of confidence in a substantial portion of the financial system that is serious enough to have adverse consequences for the real economy’.¹⁹² Whereas systemic risk is cited as the most common rationale for regulations in the banking industry, counter-party risk in wholesale markets has recently become a matter of importance in both academia and policy markers. In theory, a systemic event in securities markets, exemplified in the insolvency of a service provider or massive fraud by issuers, may have a severe impact on the real economy in three ways. Firstly, it may trigger a domino effect that will affect other financial institutions and undermine confidence in whole financial markets.¹⁹³ Secondly, it may result in a subsequent decrease in levels of engagement so that fewer resources are available to be allocated through securities markets;¹⁹⁴ and, finally, the disappearance of a financial institution may lead to the disappearance of information related to persons

¹⁹⁰ Ibid, 24

¹⁹¹ Ibid, 20

¹⁹² Darryll Hendricks, ‘Defining Systemic Risk’ (2009) Pew Financial Reform Task Force, 2. The report is available at the following website: <http://www.pewfr.org/project_reports_detail?id=0012> accessed 29 June 2011

¹⁹³ See a speech by Dominique Strauss-Kahn, Managing Director of International Monetary Fund, ‘Crisis Management and Policy Coordination: Do We Need a New Global Framework?’ (May 2009) <<http://www.imf.org/external/np/speeches/2009/051509.htm>> accessed 29 June 2011; Alan Page and Robert Ferguson (n 105) 20

¹⁹⁴ Strauss-Kahn, *ibid*

and projects that the failed institution was engaging with.¹⁹⁵ In practice, the existence of financial institutions so large that their failure is deemed to have a severe impact on the economy, also known as ‘too big to fail’, is currently an ongoing concern for policy makers in terms of how to reduce the likelihood of such an event or its impact. An important technique is the imposition of prudential regulation as to minimum liquidity and capital requirements.

Accordingly, it could be claimed that securities regulations are necessary to reduce the informational advantages in the market, ensure the solvency of financial institutions, and protect investors against malpractices by participants which may affect the integrity of the market. For each issue a solution to the problem is proposed: disclosure, prudential requirements and the conduct of business, respectively.

As far as the protection of investors as a justification for securities regulations is concerned, it raises the question of *who* is eligible for protection and from *what* behaviour. Any systematic research attempting to approach questions of the concept of investor protection from a cross-country perspective will likely end with confusion rather than clarity as a result of different national and theoretical frameworks.

Essentially, countries may differ in terms of protecting whom from what. For instance, Allen and Herring point out that, whereas insider dealing has been outlawed in the US since the 1930s, ‘insider trading was not illegal in Germany nor effectively policed in Japan’ until recently.¹⁹⁶ The situation changed in these two countries because of the introduction of the Insider Trading Directive of the European Union in the former, and the disclosure of insider dealing cases in the latter.¹⁹⁷

¹⁹⁵ Stiglitz (n 60) calls this information ‘informational capital’.

¹⁹⁶ Ibid, 23

¹⁹⁷ Richard Herring Robert Litan, *Financial Regulation in the Global Economy*, cited in Allen and Herring (n 186) 23

Furthermore, confusion as to how investor protection should be provided is evident in the literature on securities markets, economy and regulations. Such confusion exists because, firstly, the term has been used so broadly by some scholars to the extent that it overlaps conceptually with other justifications for different kind from misconduct.¹⁹⁸ For example, investor protection has been used as the basis for measures taken to reduce systemic risks of the insolvency of financial institutions, whereas these are not based on the theoretical justifications for securities regulations based on disclosure and anti-fraud.¹⁹⁹

Secondly, there are different conceptual perspectives as to the existing problems in securities markets and different views as how to solve these problems. There is little agreement as to the subject, but nonetheless, it is possible to identify three major strands of explanation in the literature: economic, political and moral. Each type of explanation suggests different measures for investor protection initiatives. A little explanation is necessarily to evaluate the benefits and shortcomings of each strand.

The first and most dominant strand is the economic perspective on investor protection. This suggests that state intervention on the basis of investor protection is needed to increase efficiency in securities markets by widening the engagement of economic agents. It should be emphasised that this explanation is different from the rationale of enhancing efficiency. Theories underpinning the economic efficiency rationale tend to see markets as a whole and aim to decrease costs in the financial

¹⁹⁸ Colin Mayer, 'Regulatory Principles and Financial Services and Markets Act 2000' ch. in Eilis Ferran and Charles Goodhart (eds), *Regulating Financial Services and Markets in the 21st Century* (Hart 2001) 29; Laura Costanzo and John Ashton, 'Product Innovation and Consumer Choice in the UK Financial Services Industry' (2006) 14 *JFR&C* 285; Andromachi Georgosouli, 'The Debate Over the Economic Rationale for Investor Protection Regulation: A Critical Appraisal' (2007) 15 *JFR&C*. 236; Peter Cartwright, *Consumer Protection in Financial Services* (Kluwer Law International 1999) 50-51

¹⁹⁹ 'The second fundamental rationale for financial regulation is the protection of investors against excessive prices or opportunistic behavior by providers of financial services ... Antitrust enforcement is the most obvious policy tool to counter excessive prices' in Allen and Herring (n 186) 10-11

system. Theories based on the rationale of investor protection which support economic efficiency are distinguished by their focus on increasing investors' engagement with financial markets in general and securities markets in particular. The justification, subsequently, focuses on the behaviour of investors rather than pure cost analysis.

The economic explanation of investor protection poses a difficulty to this thesis. Different economic models and hypotheses are provided to deal with the type of specific securities market in question, whether, equity, bonds, on-exchange or over the counter. To cover them all is not within the remit of this thesis, nor does the limitation imposed by space permit such an exercise. Therefore, the following discussion is narrowed towards making some generalisations and proving some examples.

A good starting point is Llewellyn's paper 'The Economic Rationale for Financial Regulation',²⁰⁰ where he identifies seven different perspectives for how to look systemically at problems in financial markets in general, and securities markets in particular: (1) potential systemic problems associated with externalities (a particular form of market failure); (2) the correction of other market imperfections and failures; (3) the need for the monitoring of financial firms and the economies of scale that exist in this activity; (4) the need for consumer confidence which also has a positive externality; (5) the potential for gridlock, with associated adverse selection and moral hazard problems; (6) moral hazard associated with the revealed preference of governments to create safety net arrangements such as lender of last resort, deposit insurance, and compensation schemes; and (7) consumer demand for regulation in order to gain a degree of assurance and lower transactions costs.

²⁰⁰ David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) FSA, Occasional Paper No. 1, <<http://www.fsa.gov.uk/pubs/policy/P14.pdf>> accessed 29 June 2011

Given the complexity of the economic explanations within these different perspectives, it is possible to identify different explanations reaching different conclusions and extremely different recommendations, from no-regulation at all to detailed regulations. By way of illustration, an important question concerns when there is a need to introduce a new regulation, and two broad themes of explanation can be identified.

The first theme includes economic models that are based on so-called ‘rational expectation theory’. This theory states that investors are self-interested agents who are rational in making their own decisions.²⁰¹ It presumes that a rational investor assumes that other professional participants, such as brokers and corporate managers, are self-interested as well. An investor would assume, therefore, that corporate insiders or a professional participants will steal money if they can do so, and subsequently a rational investor would hesitate to invest (especially in intangible assets such as bonds or shares) unless he or she is presented with enough evidence to show that professional participants face external constraints that deter them from defrauding them or stealing their money. It follows that a rational investor would be willing to invest should he or she assume that a legal system would effectively deter negligence, disloyalty, and dishonesty. If the legal system fails, rational investors will be the first to recognise that and to remove their money from the market and refuse to invest.²⁰² Within this framework, it could be suggested that the role of a state is to assure investors that there are appropriate measures provided by a regulatory regime that constrain professional participants from defrauding investors.

²⁰¹ Stanford Grossman, ‘An Introduction to the Theory of Rational Expectations Under Asymmetric Information’ (1981) 48 Rev. Econ. Stud. 541; Burton Malkiel, *A Random Walk Down Wall Street: A Time-Tested Strategy for Successful Investing* (Norton 1999)

²⁰² Roberta Romano, ‘Empowering Investors: A Market Approach to Securities Regulation’ (1998) 107 Yale L.J. 2359, 2368

The second theme is not only different from the first, but also advances economic models that undermine the main assumption in the previous economic explanations, namely the rationality of investors in securities markets.²⁰³ There are different proposals based on the irrationality of investors, but the economic model provided by Professor Stout can exemplify this theme since it is based on trust and confidence.

Stout points to the failure of the theory of rational expectations to explain some irrational behaviour by investors in financial markets. To solve the puzzle, she suggests an understanding of the role of trust.²⁰⁴ She claims that investors are willing to believe that at least some people or some institutions might be trustworthy because it is more convenient or cost-saving to do so.²⁰⁵ Trusting investors behave in this way with people who have shown honest and co-operative behaviour in the past and assume that such persons will continue to behave in a similar way in the future (in contrast to a rational expectation investor who neglects past behaviour).²⁰⁶ Stout tells us that trust can encompass both institutions and systems. ‘Trust’ in humans ‘...is so strong and universal that many people are prepared to believe ... in the innate character or trustworthiness of things - including perhaps such abstract things such as “the law” or “the stock market”’.²⁰⁷ Consequently, she claims that trusting investors

²⁰³ For example on the basis of cognitive weaknesses in individuals, see Emiliios Avgouleas, ‘Reforming Investor Protection Regulation: The Impact of Cognitive Biases’ in Michael Faure and Frank Stephen (eds), *Essays in the Law and Economics of Regulation: In Honour of Anthony Ogus* (Intersentia 2008)

²⁰⁴ Lynn Stout, ‘Trust Behavior: The Essential Foundation of Securities Markets’ (UCLA School of Law/ Law-Econ Research Paper No. 09-15, 2009) 12-14 <<http://ssrn.com/abstract=144202>> accessed 29 June 2011

²⁰⁵ Similar emphasis on the importance of trust is mentioned by other writers: it is noted that ‘trust is a kind of social glue that allows people to interact at low transaction costs’ in Larry Ribstein, ‘Law v. Trust’ (2001) 81 B.U. L. Rev. 553; Lynn Stout, ‘The Investor Confidence Game’ (2002) 68 Brook. L. Rev. 407, 428

²⁰⁶ Stout ‘Trust Behavior: The Essential Foundation of Securities Markets’ (n 204) 416. Stout also claims that ‘...real people behave as if they believe that, for some reason, some players refrain from opportunistic behavior even when they could safely indulge in it’, 425

²⁰⁷ *Ibid*, 427. See further discussion in Peter Huang, ‘Trust, Guilt, and Securities Regulation’ (2003) 151 U. Pa. L. Rev. 1059; Peter Huang, ‘Emotional Impact Analysis in Financial Regulation: Going

may not trust a manager, broker or advisor, but they, nonetheless, invest because ‘... they rely on the legal system (including legally enforceable contracts) to discourage managers, brokers and investment advisors from behaving like the scoundrels that they are’.²⁰⁸ When the trust in the system is shaken, by financial scandal for example, to the extent that it requires a rapid response, the state is the only actor who can provide reassurance and maintain the confidence of investors in financial markets.²⁰⁹ It could be suggested, thus, that according to this theme of economic explanations, state intervention is necessary to maintain the trust of investors in the legal system that controls financial markets in order to ensure an optimal level of engagement.

Both themes of economic explanations suffer from flaws. They presuppose that investment and engagement with financial markets are voluntary acts. But investing, as a voluntary activity, may no longer be an option; many citizens, particularly in developed countries, are expected to assume responsibility for their financial security in retirement, and thus have no choice but to save and invest and, therefore, become investors.

Moreover, rational investor theory explanations ignore the fact that there are irrational and unsophisticated investors in financial markets. The theory considers them as ‘...a weak animal’ which ‘...must sadly but necessarily be culled out of the investing herd in order to improve the species’.²¹⁰ On the other hand, economic explanations such as those relying on trust or cognitive weaknesses in individuals cannot provide answers to questions in respect of the criteria needed to determine the scope and the need for intervention: trust among which investors? Are foreign or

Beyond Cost-Benefit Analysis’ (Temple University Legal Studies Research Paper No. 2006-21, 2006) < <http://ssrn.com/abstract=870453> > accessed 29 June 2011

²⁰⁸ Stout (n 204) 426

²⁰⁹ Ibid, 435; Tamar Frankel, ‘Regulation and Investors’ Trust in the Securities Market’ (2003) 68 Brook. L. Rev. 439, 444

²¹⁰ Stout (n 204) 430

domestic investors more important? What is the level of mistrust among investors that requires state intervention? And how can we measure trust?

Having considered the economic strand of explanation, more importance may be ascribed to the other two non-economic explanations for state intervention on the grounds of investor protection: the political and moral.

The political explanation suggests that if citizens are required to invest in a market that is perceived as unfair, or treating them unfairly, investors may direct their frustration towards politicians or the political system.²¹¹ Hence, the state has to intervene in securities markets to ensure the stability of the political system within a country. It is for this reason that major securities market reforms have been observed to follow market scandals or crashes.²¹²

However, our case studies suggest otherwise. While it is observed that changes in securities law in the UK tend to occur at times of shift between political parties, it has never been suggested that those changes were proposed to avoid a threat to the stability of the political system.²¹³ In the same vein, the change in securities law in Saudi Arabia is demonstrated to be part of the preparation for membership of the WTO.²¹⁴ While it might be argued that membership of the WTO was sought partly because of high unemployment which might generate political instability, high unemployment in fact supported a change in the economic management model used in the country. In other words, the change in securities law in Saudi Arabia was a means for economic restructuring, rather than a response to a political threat arising from perceived unfair treatment within the markets themselves. Accordingly, it is unlikely that the political explanations would suit the case studies of this research.

²¹¹ Stuart Banner, 'What Causes New Securities Regulation--300 Years of Evidence' (1997) 75 Wash. U. L. Q. 849, 850

²¹² Stout (n 205) 430

²¹³ See chapter four Part I (a) and (b)

²¹⁴ See chapter five Part I (e)

An equally compelling justification for investor protection is morality. According to this view, since citizens must invest in the market by law or by need, as a result of the state's retreat from providing a financial safety net, the state then has a moral obligation towards its citizens to ensure that investors are treated fairly and honestly.²¹⁵ However, moral explanations do not provide direction as to the limitations and standards of appropriateness for a state to intervene. Nor does this explanation specify the source of moral value in financial markets such as religion, fairness, equality, or justice, each of which may lead to different conclusions. Another critical weakness of this explanation is the fact that similar measures have been taken in financial markets in different countries which hold different moral cultures, such as the prohibition of loan sharks in the UK and Saudi Arabia.

Taking all three strands together, it is reasonable to suggest that it would be too simplistic to argue or to seek explanation of securities regulations upon the basis of any single theory or approach. The importance of these theories, nonetheless, could be claimed to lie in their influence on methodology, as noted by Baldwin and Cave:

‘ ... in seeking to explain particular regulatory developments, an awareness of the variety available explanations does help the observer to evaluate the insights offered by different theories, to develop a sense of the limitations and assumptions underpinning those theories, and to identify the kind of information necessary for applying and testing them’.²¹⁶

Thus, it can be said that the various explanations are of help in advancing knowledge about a particular special phenomenon, which here is the concept of investor protection regulations in securities markets.

²¹⁵ Barbara Black, ‘Are Retail Investors Better Off Today’ (2007) 2 *Brook. J. Corp. Fin. & Com. L.* 301, 305

²¹⁶ Baldwin and Cave (n 35) 32

One of the fundamental conclusions from the forgoing discussion is that the aims should not be confused with the means of securities regulations grounded in investor protection. Economic explanations state that deterring malpractice is not an objective for securities regulations *per se*, but rather to cut down on the unnecessary misuse of resources as a result of the unwillingness of investors to invest or participate in securities markets. In other words, it is all about increasing the efficiency of securities markets; hence if markets are efficient there are no grounds for investor additional protection regulations. Morality as a ground is suggested to be too broad to constitute a universal explanation applicable irrespective of context or the moral values of societies and hence to provide a coherent conceptual framework for investor protection. The political argument is claimed to limit the necessity of regulation to pure political motivations or threats of instability; it proposes that if there is no risk to the political interest, there is no need for regulation. However, the analysis advanced in this thesis is that a political explanation for regulations suggests regulations based on investor protection could be introduced, notwithstanding the nonexistence of any threat of any political instability.

Having said that, the following central discussion in this thesis rests strongly on the economic rather than moral and political explanations. A key factor in this is the fact that regulations aim to implement broader social policy of enhancing the social welfare by increasing the efficiency of process for allocation the limited resources within the economy. Moreover, the analysis focuses on the deterrence rationale for the private enforcement of regulations, as noted at the beginning of this chapter, rather than the compensatory or fairness outcome of the markets. Little considerations, therefore, should be given to answer questions related to morality and fairness.

E) Concluding Remarks for Part I

Part I started by attempting to define what securities markets are. It is illustrated that there is no agreement in the literature as to exactly what securities markets are. Consequently, the chapter endeavoured to provide a definition of securities markets on the basis of the meaning of markets and why they exist. Following this exercise, it was proposed that the term securities market is any organised process in an identifiable location or system through which financial contracts or claims which represent obligations or rights that have their own value and are transferable are exchanged, issued and traded. It is noted that there are different securities markets but the focus of this inquiry is mainly on capital markets, which include stock markets, bonds markets, and derivatives.

Having provided for a definition of securities markets, Part I attempted to demonstrate the relatively higher importance given to securities markets in modern times. It is shown that securities markets play a vital role in increasing the efficiency of the economy by working as a bridge between savings and wealth enhancing projects. Also, securities markets work to increase savings and distribute both credit and liquidity as well as discovering market prices for risks, events, management and liquidity. In addition, it is claimed that the spread of market oriented structures for economic activities provides additional support for the importance of securities markets in general and capital markets in particular, due to the important role they enjoy in the process of shifting towards a market economy model as well as transferring the public ownership of production units to the private sector. Accordingly, it is maintained that there are public policy considerations in ensuring the efficient functioning of securities markets that justify the attention given to them by policymakers, which is an answer to one of the research questions of this study.

This part has also attempted to answer one of the present research questions presented as a sub-question of the thesis, which is to assess the importance of secondary securities markets. It is pointed out that secondary markets play an important role in enhancing confidence in primary markets, subsequently increasing the supply of credit. Furthermore, it is suggested that secondary markets benefit the economy by providing prices that can be utilized to guide the process of the allocation of capital and wealth.

It is pointed out that problems of disclosure and the quality of assets are of the essence of the regulation of securities markets. The lack of incentive for managements and issuers to provide the information needed to assess the quality of the assets may render price discovery in the markets unreliable. Accordingly, it is claimed that disclosure requirements aim to bridge the gap in the informational disadvantages against investors. Another rationale for regulations is to protect investors from sharp practice and opportunistic behaviour by participants in the markets which may undermine the integrity of the markets and investor confidence in them.

Accordingly, it is argued that it is worthwhile for policymakers to introduce regulations that aim to ensure the efficient functioning securities markets, including secondary one, by reducing the informational disadvantages, ensuring the solvency of participants, and maintaining investor confidence against opportunistic behaviour by participants in these markets. It follows that securities markets regulations could be categorised as regulations that aim to increase disclosure, ensure the solvency of participants such as prudential requirements, and to protect investors from malpractice by participants in terms of the conduct of business.²¹⁷

²¹⁷ It should be noted different views exists, but a large agreement as to the underlying issues. Goodhart, for instance, refers to the reasons for public sector regulations as to protect customers against monopolistic exploitation, to provide smaller, less informed client with protection, and ensure systemic stability; Charles Goodhart, *Financial Regulation: Why, How, and Where Now?* (Routledge

However, regardless of what good regulations are introduced or what they aim to achieve, they are in themselves without any practical benefits. ‘A statute’ noted Walter, ‘is merely a suggestion, rather than a mandate, if it cannot be enforced.’ Ensuring compliance with and the enforcement of regulations is a necessary, but not sufficient, condition to ensure an optimal regulatory regime is in place. Whereas the literature focusing on enforcement in securities markets emphasises the importance of public enforcement, in comparison less attention has been paid to the role of private enforcement of securities regulations as a policy choice and elements of institutional design in the overall enforcement framework of securities regulations. Accordingly, the next part focuses on the subject of the private enforcement of securities regulations.

Part II Private Enforcement of Securities Regulations

Part I demonstrates the importance securities regulations in deterring malpractice and opportunistic behaviour, in addition to reducing systemic risk as well as informational disadvantages, that are deemed to undermine the integrity of securities markets. However, introducing regulations and rules is one thing, ensuring compliance with them is completely different. While mechanisms to increase compliance with securities regulations have been identified and promoted, such as ‘fit and proper tests’ for both financial firms and the main personnel working in them, it is more likely that compliance with conduct of business rules would rely on strict enforcement with civil and criminal sanctions.²¹⁸

1999) 4. The thesis in agreement with Goodhart but points out the monopolistic problem is rooted in informational disadvantages.

²¹⁸ Allen and Herring (n 186) 9

The emphasis of the relevant empirical and theoretical legal literature on conduct of business regulations aiming to protect investors, with the exception of some studies dealing with the US which consider class-actions system, may be classified as falling within one of two broad themes: public and private. A great deal of the literature focuses on public enforcement, especially concerning insider dealing and conflict of interests.

Private enforcement as a means to ensure compliance, however, has received far less attention in comparative debate. Even IOSCIO documents rarely refer to private enforcement as an important part of securities regulations; nor does IOSCO suggest how to implement an effective regulatory regime taking account of private enforcement of securities regulations. In the absence of any guidance or optimal framework, countries have taken different approaches in terms of how to implement private enforcement within their regulatory regime.

Accordingly, this chapter focuses on the important role of private enforcement of securities regulations as facilitated by the regulatory regime and how it can support public enforcement. It starts by providing a history of private enforcement within securities regulations in the U.S. Then, it reviews the debate about the pure public enforcement versus private enforcement of securities regulations and argues that there is a role for private enforcement in an optimal regulatory regime. However, given the absence of any accepted framework, this section identifies some problems with enforcement by unsophisticated private actors, especially in retail sectors, who are considered in need of additional substantive protection. It demonstrates how regulation might facilitate such action and what a regulatory regime of private enforcement should take into account.

A) The History of Regulatory Private Action of Conduct of Business in Securities Regulations

The role of private enforcement in securities regulations has been recognised since the introduction of modern securities regulations in the U.S in the 1930s. At that time, Congress affirmed the right of citizens to seek redress for non-compliance or violation of securities legislations.²¹⁹ The Securities Act 1933 provided an express private right of action against signers of registration statements containing material misstatements or omissions.²²⁰ The Securities and Exchange Act of 1934 expressly provided for a private right to sue against certain violations, for instance, the rights to sue for manipulation or deception,²²¹ to recover profit gained by corporate insiders,²²² and to recover damages for false or misleading statements.²²³ The Act also imposed certain limitation on these rights.²²⁴

Interestingly, the most frequently cited provisions for an anti-fraud right of action, which are s.10(b) and Rule 10b of the Securities and Exchange Act, does not itself expressly provide for an right of action for non-fraudulent actions or statements by participants . The federal courts in the U.S. over the following years interpreted the statutes to imply a private right of action to sue for non-fraudulent acts.²²⁵ Initially, the recognition of an implied private right to sue was considered as ‘an exercise of the

²¹⁹ For more discussion as the subject of private enforcement of public law in the U.S., see Stephenson (n 107)

²²⁰ Section 11 of the Securities Act of 1933

²²¹ Section 9(f) of the Securities Exchange Act of 1934

²²² Section 16(b) of the Securities Exchange Act of 1934

²²³ Section 18(a) of the Securities Exchange Act of 1934

²²⁴ Section 9(f) of the Securities and Exchange Act (provisions for costs and attorney’s fees), and Section 13 of the Securities Act (statute of limitations for Section 11 and 12(a) (2))

²²⁵ For example in *Kardon et al. v. National Gypsum Co. et al.*, 73 F.Supp. 798, 802 (E.D Penn.)(1947) and *Superintendent of Insurance of the State of New York v. Bankers life and Casualty Company et al.*, 404 U.S. 6, 13 & n.9 (1971). For more discussion, see SEC commissioner’s speech Elisse Walter, ‘Remarks Before the FINRA Institute’ (Wharton Certified Regulatory and Compliance Professional (CRCP) Program, 2011), available on the internet at <http://www.sec.gov/news/speech/2011/spch110811ebw.htm#P24_4565> accessed 29 June 2011

federal courts' common law power to supply an appropriate remedy for every statutorily conferred right' and hence private action based on Rule 10b flourished.²²⁶

However, the Supreme Court of the U.S. in the mid 1970s, in the case *Blue Chip Stamps v. Manor Drug Stores*, shifted its rationale for such recognition to be an exercise of statutory interpretation, at least with respect to private claims under Rule 10b.²²⁷ Such a move was driven by the court's 'belief that Rule 10b-5 "vexatious" litigation needed to be constrained'.²²⁸ Accordingly, the role of the court was changed, since it:

'...will no longer consider policy arguments such as the need to compensate injured parties or the useful role that these parties could play as private attorneys general when deciding whether or not to imply a private right of action. Rather, congressional intent alone is supposed to govern.'²²⁹

Moreover, Walter, a Commissioner of the SEC, notably described the Supreme Court's decisions since *Blue Chip Stamps v. Manor Drug* as 'hostility towards private rights'. Walter pointed out that the Supreme Court not only refused to recognise implied private rights in subsequent cases,²³⁰ but also restricted the scope of the previously recognised private rights. For instance, the Supreme Court in *Morrison v. National Australia Bank*²³¹ stated that Rule 10(b) did not provide 'a private cause of action against foreign and American defendants for misconduct in connection with securities traded on foreign exchanges', and that it applied only to transactions in

²²⁶ Stephenson (n 107) 103

²²⁷ *Blue Chip Stamps et al. v. Manor Drug Stores, etc.*, 421 U.S. 723 (1975)

²²⁸ Elisse Walter (n 225)

²²⁹ Stephenson (n 107) 105

²³⁰ *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)

²³¹ *Morrison v. National Australia Bank Ltd.*, 130 S.Ct. 2869 (2010)

securities listed on domestic exchanges. Such a restriction implies that private enforcement is not recognised in cases of fraud of securities traded on foreign exchanges.

In addition to restricting the scope of Rule 10(b), the court in a subsequent decision restricted the liability of those involved in fraud activities. In 2011, the Supreme Court held that an investment adviser cannot be liable under rule 10(b) for false statements included in mutual funds' prospectuses.²³² The court was of the opinion that a private right should have 'narrow dimensions' and held that the investment adviser was not liable because it did not make the statements.²³³

Accordingly, given the scope of this thesis on business conduct regulations, specifically the issue of suitability which is demonstrated to develop under Rule-10(b), these historical developments suggest that one should be cautious about relying on s.10-b of the Securities and Exchange Act as a central argument for the promotion for the private enforcement of securities regulations. Firstly, it was the courts that developed the private right of action under Rule-10(b) for non-fraudulent acts, rather than it being introduced as part of the institutional design of securities regulations. It is true that s.10(b) has played a more important role than other express right to private action in statutes in securities regulations, as well as being part of the current institutional design of U.S. securities regulatory regime.²³⁴ However, it was not initially intended to this. Secondly, as well as the SEC as a means of public enforcement, private parties can bring an action based on Rule 10(b). However, it is

²³² *Janus Capital Group, Inc. et al. v. First Derivative Traders*, Opinion No. 09-525 (2011)

²³³ *Ibid*, 6

²³⁴ For instance, s.18 provides a cause of action and the liability of any person who makes false or misleading statements in a document filed with the SEC. However, actions in cases of false statements provided to the SEC has been brought on reliance on s.10(b) rather than s.18 because of the higher standards of reliance imposed by the statute; see John Occhipinti, 'Section 18 of the Securities Exchange Act of 1934: Putting the Bite Back Into the Toothless Tiger', (1978) 47 *Fordham Law Review* 115, 116

unclear how much consideration is given to private enforcement by U.S. legislators in the recent regulatory reforms, known as Dodd-Frank, in comparison to public enforcement by a regulatory agency. For example, following the *Morrison v. National Australia Bank* case that rejected an application of rule 10-b on fraud committed to securities traded on foreign exchanges, s.929P of the Dodd-Frank Act confirms the SEC authority in cases involving securities traded outside the U.S.²³⁵ In contrast, the Dodd-Frank Act does not confirm such authority to a private right to sue; s. 929Y required the Commission to solicit public comment and conduct a study to determine the extent to which private rights under the antifraud provisions should be extended across international boundaries and to submit the commission's report to the Congress. This suggests that public enforcement will be more likely to be distinguished from private plaintiffs in the future, but it is unclear how.

Lastly, following the Supreme Court's arguments, many scholars have concluded that court decisions implying a private cause of action which was not expressly provided are not rationalised in terms of compensation as much as deterrence and improving the overall enforcement of statutes.²³⁶ Accordingly, it could be argued that anti-fraud action reliant on s.10(b) and Rule 10(b) have essentially evolved as a means of deterrence rather than compensation and, therefore, it is possibly to consider this cause of action as a means for enforcement aiming at deterrence within the enforcement framework for securities regulations.

²³⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173, 2010

²³⁶ Stephenson (n 107) 104

B) Pure Public Enforcement Or A Role for Private Enforcement: The Debate

There are two divergent approaches to arguments concerning enforcement of securities regulations: public and private. Public enforcement refers to enforcement actions taken by a regulator to ensure that investors are protected, and that fair, orderly and efficient capital markets are maintained. The term ‘private enforcement’ is used to differentiate between the enforcement of the law by public authorities and by individuals. Private enforcement refers to ‘individuals or groups whose interests the law or regulation is designed to protect’ and are able to ‘enforce compliance obligations directly against infringers in the civil courts and recover their losses directly’.²³⁷

It should be noted that public enforcement is not by any means limited to one regulatory agency; in some cases where criminal sanctions are imposed by securities statutes, criminal enforcement by the criminal prosecution authority may take place. The following discussion, however, is more focused on civil rather than criminal liability and considers unacceptable, but not criminal, behaviour as defined by the regulatory agency responsible for the enforcement of conduct of business regulations.

I. Disadvantage of Private Enforcement

This section considers the argument that public enforcement is a sufficient condition for effective enforcement of securities regulation.

Fundamentally, there is a strong case for the claim that public enforcement is a necessary condition for effective securities regulations. Experience demonstrates that there is a need for systematic enforcement within securities markets.²³⁸ In the

²³⁷ Gray (n 96)

²³⁸ Ibid, also in Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, ‘What Works in Securities Laws?’ (2006) 61 J. Finance 1

transition process from a state-controlled towards a market economy, similar to that underway in Saudi Arabia through its privatisation programme, Poland adopted an SEC style of enforcement and a rapid development of the stock market was observed; whereas in the neighbouring Czech republic ‘the hands off’ approach to enforcement caused the near collapse of its stock market.²³⁹

Different explanations offered as to the centrality of the role of public enforcement. The main argument is that the incentives for private enforcement are insufficient to support compliance with regulation. A public enforcement agency is more focused and expert, and is able to interpret rules properly as well as sanction misconduct. either on its own or by bringing suits against violators.

In addition to the benefits of public enforcement, its supporters correctly point out some shortcomings associated with reliance on the private enforcement of securities regulations. The principal shortcoming is said to be that private enforcement based on deterrence rather than compensatory justifications are very difficult to control. This poses a dilemma where, on one hand private enforcement is rigid and very difficult to adjust, and on the other hand deterrence is based on incomplete information and sometimes ‘decisions are guided by intuition’.²⁴⁰

An additional shortcoming is that broad reliance on private enforcement may result in excessive litigation or enforcement, which may restrict any adjustment of

²³⁹ Edward Glaeser, Simon Johnson and Andrei Shleifer, ‘Coase Versus the Coasians’ (2001) 116 *Quart. J. Econ.* 853. It is claimed that the two countries provide the ‘perfect experiment, because the two countries share roughly similar incomes, economic policies and judiciary quality’, Rafael La Porta, ‘Comment on “Ownership Structure, Legal Protections, and Corporate Governance” by I. J. Alexander Dyck’ pt of Boris Pleskovic and Nicholas Stern (eds), *Annual World Bank Conference on Development Economics 2000* (World Bank 2001) 368

²⁴⁰ Wen Wang, ‘Private/Public Enforcement of Securities Regulation: The Case of Taiwan’s Investor Protection Center’ (2011 Annual Meeting of the Asian Law and Economics Association, July 2011) <<http://www.sef.hku.hk/aslea2011/private/paper/10.%20Wang%20Wen%20yeu%20full%20paper.pdf>> accessed 29 October 2011

enforcement policy of the regulatory regime.²⁴¹ The maximum enforcement is not necessarily its optimal level and could result in the system of private enforcement being misused or abused for private gains which would conflict with social or economic policies, such as, for instance, the benefit to a private business of damaging the reputation of a competitor by bringing a private lawsuit.²⁴²

Moreover, enforcement actions by private parties may interfere with public enforcement and undermine the benefits of enforcement by its agencies. Many public enforcement policies, such as principles-based, and strategies, such as coercion or cooperation, rely on a cooperative relationship between regulators and regulated entities which is essential to ‘establish a workable and consistent regulatory system.’²⁴³ The threat of private enforcement is that it may hinder efforts by public agencies to establish an accepted standard of conduct within an industry’s self-regulatory body. A further criticism associated with private enforcement concerns costs. Private parties are less concerned than public enforcement agencies with the economic and social costs of specific enforcement action.²⁴⁴ For instance, numerous private enforcement actions may drain judicial resources.²⁴⁵

Such problems identified with private enforcement are deemed to justify reliance on public enforcement alone in order to ensure a higher level of compliance with regulations.²⁴⁶

²⁴¹ Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard Uni. Press 2004) 483

²⁴² Joseph Brodley, ‘Antitrust Standing in Private Merger Cases: Reconciling Private Incentives and Public Enforcement Goals’ (1995) 94 Mich. L. Rev. 45

²⁴³ Richard Stewart and Cass Sunstein, ‘Public Programs and Private Rights’ (1982) 95 Harv. L. Rev. 1292, 1293

²⁴⁴ Tamar Frankel, ‘Implied Rights of Action’ (1981) 67 Va. L. Rev. 571

²⁴⁵ Donald Zeigler, ‘Rights, Rights of Action, and Remedies: An Integrated Approach’ (2001) 76 Wash. L. Rev. 146

²⁴⁶ For further discussion as to the relationship between enforcement strategy and compliance, see Mary Condon and Poonam Puri, ‘The Role of Compliance in Securities Regulatory Enforcement’ (2006) Commissioned by the Task Force to Modernize Securities Legislation in Canada <[http://www.tfmsl.ca/docs/v6\(1\)%20condonpuri.pdf](http://www.tfmsl.ca/docs/v6(1)%20condonpuri.pdf)> accessed 29 June 2011

II. Advantages of Private Enforcement

The foregoing disadvantages notwithstanding, private enforcement of public securities law and regulations can provide a number of benefits, and in many cases can be productive rather than counter-productive for at least three reasons. First, private enforcement facilitates a more efficient allocation of resources by providing resources additional to those of the regulatory enforcement framework. Second, private enforcement can provide a check on public agencies preventing them from shirking their responsibilities. Third, private enforcement can facilitate a reduction in the ambiguity associated with the writing of financial contracts, and hence reduce costs. Whereas these advantages do not necessarily refute or negate the benefits associated with public enforcement discussed above, they suggest that there is a case for private enforcement having a role in supporting a regulatory regime which public enforcement cannot fulfil.

a. Providing additional resources for enforcement

Public agencies have limited budgetary discretion and must work within limited resources to enforce the law adequately. Enforcement by private parties would increase the resources available to law enforcement and hence reinforce government enforcement efforts.²⁴⁷ Limiting the role of private enforcement or relying on public enforcement alone would place more pressure on regulators to be ‘the sole guardians of statutes’.²⁴⁸

The resource constraint on public agencies make them unable to bring every case which is considered important, and many factors need to be considered in deciding whether or not to bring an action such as the extent of the harm, the deterrent

²⁴⁷ Barry Boyer and Errol Meidinger, ‘Privatizing Regulatory Enforcement: A Preliminary Assessment of Citizen Suits Under Federal Environmental Laws’ (1985) 34 *Buff. L. Rev.* 838

²⁴⁸ Elisse Walter (n 225)

impact of the case on future conduct across the market. If private enforcement is not available, legally unacceptable behaviour may go uncorrected and may fail both to deter wrongdoing and improve standards of quality and safety within securities markets. Consequently, fewer agents within the economy would be willing to engage with securities markets due to lack of trust in the behaviour of service providers or issuers.²⁴⁹

In short, it could be argued that there are cases which, even though public agencies consider them socially and economically worth enforcing, due to resource constraints they are unable to pursue. Private enforcement, therefore, could arguably provide the needed resources in these areas.

b. Private Enforcement as a Check on Lax Enforcement

Another potential benefit of private enforcement is that it can correct any laxity in enforcement by the public enforcement agencies. Lax enforcement refers to the tendency of government regulators to underenforce a statute or statutory requirements as a result of political pressure, lobbying by regulated entities, or the self-interest of the regulators themselves.²⁵⁰

Research on the subject of private enforcement of public laws points out that private actions can address lax enforcement by public agencies in two ways. Firstly, private lawsuits can be a substitute for the enforcement actions of the agency.²⁵¹ Secondly, and indirectly, a private lawsuit ‘can prod an agency into action, either by

²⁴⁹ Iain Ramsay, *Rationales for Intervention in the Consumer Market Place*, (Office of Fair Trading 1984) 15

²⁵⁰ Stewart and Sunstein (n 243) 1294

²⁵¹ Matthew Zinn, ‘Policing Environmental Regulatory Enforcement: Cooperation, Capture, and Citizen Suits’ (2002) 21 *Stan. Env’tl. L.J.* 133, 134

shaming it or by forcing it to intervene to take over the management of those private suits where the government cares about the outcome.²⁵²

Moreover, though this justification for private enforcement is most often associated with legislative distrust of the executive branch, it is likely that in some cases, due to lack of resources, the agency is unaware of non-compliance or statutory breach by regulatees. The ability to detect violation is necessary for effective enforcement, and private parties are more likely to be better positioned than public agencies to detect violation or non-compliance since they are directly affected by a defendant's conduct or misconduct.²⁵³ For these reasons, it is argued that the policing of statutory violations provided by private parties is more likely to be of benefit since the latter are well-informed and have sufficient incentives to bring suits.²⁵⁴ By permitting private enforcement, an incentive for victims is created to 'detect, report and assist in the apprehension and prosecution of violators'.²⁵⁵

Moreover, lax enforcement can seriously undermine the price functioning of securities markets. It was noted previously in Part I that one function of securities markets in a market-oriented economy is price discovery for credit, liquidity, events, risks and management. Hayek points out that the most important role of prices is based on necessity; freely formed and freely adjusting market prices contain information about the plans and intentions of millions of market participants that is impossible to represent by any other means.²⁵⁶ Changes in prices reflect changing relative scarcities of input factors, goods, and services, and they thereby enable market agents to plan and to bring their subjectively formed perceptions and

²⁵² Stephenson (n 107) 110

²⁵³ Ibid, 109

²⁵⁴ Ibid, and see also Frankel. 'Implied Rights of Action' (n 245) 580

²⁵⁵ William Friedman, 'One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Markets' (2002) 27 *Brook. J. Int'l L.* 477, 512

²⁵⁶ F.A. Hayek, 'Economics and Knowledge' (1937) 4 *Economica* 33, 49

expectations of the market conditions into line with reality. The impact of mis-pricing on the relations of quality in markets can cause serious economic problems. Initially, it scarcely helps that individuals incapable of differentiating between relative qualities would rely on price as a quality indicator. Providers in these cases tend to compete on prices as there is no other available indicator of the true quality of their products or services. In such circumstances, it is highly likely that this may lead to a general depression of quality within a market and eventually the existence of the so-called 'market for lemons'.²⁵⁷

Therefore, given that some investors in securities markets are not always capable of feeding back their subjective preferences and wants to the markets,²⁵⁸ and in cases where lax enforcement exist, it would be reasonable to expect that mis-pricing in securities markets is highly likely.

c. Private enforcement and clarification of the law

There is also an advantage of private enforcement in clarifying the law. The logic of this argument is that private enforcement may decrease the costs of writing and enforcing contracts which are negotiated privately, which will subsequently increase the efficiency of securities markets by minimising both legal risk and cost of transacting.

As far as legal risk in financial markets is concerned, the premise is that financial markets cannot generally be expected to deliver outcomes in the most efficient manner if the costs and risks associated with contracting are relatively high

²⁵⁷ George Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quart. J. Econ.* 488

²⁵⁸ Neil Vidmar, 'Seeking Justice: An Empirical Map of Consumer Problems and Consumer Responses in Canada' (1988) 26 *Osgoode Hall L.J.* 757. For more illustration: Donald Mathieson and Garry Schinasi, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, (International Monetary Fund 1999) 101

for both businesses and investors. A means to decrease costs is to increase the certainty of legal rules, which is based on the assumption that legal risks increase with the increase in uncertainty of legal rules.²⁵⁹ Thus, low levels of litigation may also cause a reduction in the level of legal certainty needed in relation to securities markets.

In practice, it is evident that financial markets are able to develop more rapidly than regulatory regimes or regulatory agencies. As to the general law, courts are reactive and not proactive to developments in financial markets in general, and therefore there may be cases of specific practices where there is no regulatory guidance as to a matter of dispute.²⁶⁰ Hence, exactly what the legal position is in relation to a new product, service or practice would remain a matter of legal speculation until this is tested before a court when a dispute arises relating to such products or services.

Thus, it could be argued that there will be a need for contracting parties to go to the courts and the process will increase the clarity as to the law at this subject not only for future contracting parties, but also for the regulators.

C) A Case for Private Enforcement for Securities Regulations

Any claim that the absence of systematic enforcement might lead to market collapse, as indicated by experience, does not necessarily lead to the conclusion that no benefits accrue from private enforcement of securities statutes and regulations. Moreover, recent studies suggest that public enforcement can be effective only when the relevant government bureaucracies are efficient. For instance, it is claimed that the

²⁵⁹ McCormick, 'Legal risk, Law and Justice in a Globalising Financial Market' (n 104) 283

²⁶⁰ Katharina Pistor and Chenggang Xu C, 'Law Enforcement Under Incomplete Law: Theory and Evidence from Financial Market Regulation' (Columbia Law and Economic Working Paper No. 222, 2002) <<http://ssrn.com/abstract=1160987>> accessed 29 June 2011

effectiveness of public enforcement is statistically significant only for IPOs and earnings manipulation in countries with well-staffed regulatory bodies.²⁶¹ While the efficiency and effectiveness of the public enforcement of securities regulations are attracting more attention,²⁶² such studies still emphasise the importance of regulatory resources as an important factor in an effective securities markets regulations.²⁶³

But this approach neglects to answer an important but simple question from a public policy perspective: whether or not a comprehensive system for the civil enforcement of securities regulations which is welfare maximizing requires a combination of public and private action or pure public enforcement. It was noted by Grundfest that within the U.S. context ‘... [while] praise for private party litigation is well-deserved in many situations, the relationship between private and federal enforcement of securities laws has not been subject to rigorous analysis.’²⁶⁴ Many of the studies focusing on the U.S. context put emphasis on the impact, benefits and shortcomings of class-action suits, but less empirical emphasis is directed towards private enforcement *per se* within the design of the regime of securities regulations.

Ultimately, the issues discussed above regarding the importance of the private enforcement of securities regulations and the optimal structure of the regulatory bodies need to be put into context. The preceding discussion makes clear that the use of private suits to enforce securities laws and regulations has advantages and disadvantages. We can agree that it might be correct that private enforcement is no substitute for systematic enforcement, and it is even possible to argue that investors are better off with systematic enforcement in terms of both the effort involved and

²⁶¹ Ibid

²⁶² Jackson (n 55); Coffee (n 56); Jackson and Roe (n 56)

²⁶³ Lopez-de-Silanes, at p.26

²⁶⁴ Joseph A. Grundfes, Disimplying Private Rights of Action under the Federal Securities Laws: The Commission's Authority, cited in Nishal Ray Ramphal, The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States

costs. However, it is argued here that the debate should not be about public versus private enforcement as if they were alternatives, but rather that the use of private enforcement should complement rather than be a substitute for public enforcement. The benefits of clarity in substantive law and the risks associated with lax enforcement and inadequate resources available to public enforcers mean that private actions are likely to increase the welfare maximization aim of social policy both directly, through ensuring that an adequate level of deterrence is available, and indirectly, by clarifying the law and substituting for lax enforcement.²⁶⁵

Therefore, it is proposed in this thesis that it is a question of how to effectively and efficiently provide a framework that combines both types of enforcement. It is more likely than not that, if implemented correctly, such a combination could provide the advantages of private enforcement and at the same time mitigate the disadvantages identified.

Unfortunately, no paradigm for the optimal combination of the private and public enforcement of securities regulations has been promoted by IOSCO. It is also unfortunate that little existing research provides guidance as to what the optimal institutional design might be for private causes of action in relation to securities regulations which would be suitable internationally. Furthermore, substantive research analysing the private enforcement of financial law, including corporate and securities public law, focuses on its positive and negative impacts of class-action suits rather than of private enforcement of substantive obligations, not through class-action, let alone enforcement by retail investors. Accordingly, this thesis investigates the importance of the private enforcement of investor protection regulations in secondary

²⁶⁵ To put the matter in perspective, comparative researches in the field of enforcement by regulators of financial services illustrate that most regulators are under-resourced and understaffed; the FSA, for example, is claimed not as strong as it should be in comparison to other enforcement agencies in other common law countries; Jackson (n 55); Coffee (n 56); Jackson and Roe (n 56)

securities markets. It emphasises the application of conduct of business regulations aiming to control the behaviour of participants rather than using securities regulations to control the behaviour of managements. Therefore, given the lack of a specific paradigm which takes into account such concerns, the next section endeavours to review the issue with reference to the literature on the private enforcement of public law.

D) The Private Enforcement of Securities Markets Regulations

In Part I, it was pointed out that securities markets regulations aim to solve the informational problem through disclosure, to prohibit opportunistic behaviours as well as malpractice among participants which can undermine the integrity of markets, and to reduce systemic risk by imposing prudential requirements. While the above discussion argues that private enforcement is complementary to rather than a substitute for public enforcement, the thesis assumes that, given the different justifications, different regulations may require different frameworks for private enforcement.

Such an assumption fits well with the literature on the private enforcement of public law. In his analysis, Stephenson points out that, from the point of view of institutional design, the desirability of private enforcement in a particular policy area will depend on three criteria: (a) context-specific information about the regulatory problem; (b) the characteristics of the potential private plaintiffs; and (c) the effect of private enforcement on public enforcement efforts.²⁶⁶ Given that there are three broad rationales for securities regulations, it could be suggested, therefore, that there are three broad regulatory problems that may involve different regulatory solutions:

²⁶⁶ At p. 121

information disclosure, malpractice and conduct of business, and systemic risk reduction by imposing prudential requirements.

However, It is important to identify the regulatory issues presented by such substantive obligations and to link this to the literature about the private enforcement of public law. Only then can a list be provided of the pre-requisites for an effective private enforcement of conduct of business regulations in secondary securities markets. Critically, it is important to understand how securities markets regulations aim to protect investors from malpractice in such a way that they are likely to enhance economic activity. In other words, it is necessary to specify the link between securities regulations and the economic benefits that result in the achieving the objective of the efficient allocation of limited resources.

As a determinant of economic development through its effects on capital markets, the influence of law was empirically demonstrated for the first time in the late 1990s. Two empirical studies by La Porta et al examined shareholder and creditor rights, among other variables, in evaluating investor protection in 49 countries.²⁶⁷ La Porta et al provided valuable insights into the law and development debate, among which two are of importance here. Firstly, the two studies suggest that there is a causal link between law and economic growth stemming from aspects of company law, and in particular the protection of a shareholder's property rights which affect finance and thus eventually feed into the overall efficiency of the economy. Secondly, the two studies attribute to company law a role in determining the concentration of ownership. The authors claim that there is a positive correlation between the quality of the legal protection for minority shareholders provided by the corporate governance structure and increased concentration of ownership.

²⁶⁷ Rafael La Porta and others, 'Legal Determent of External Finance' (1997) 52 *Journal of Finance* 1131; La Porta and others, 'Law and Finance' (n 31)

In his seminal work ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’, Coffee argues that the investor protection included in a country’s corporate law has become increasingly marginalized, whereas what matters more are the investor protection rules provided by securities and exchange legislation.²⁶⁸ The latter are capable of providing more comprehensive and effective rules.²⁶⁹ Clearly, Coffee re-directs attention away from corporate law to secondary markets law as the more substantive law in generating economic growth. But while Coffee accepts the first premise of La Porta’s et al studies, he undermines the second premise by shifting the focus to those legal rules that deal with disclosure, takeovers, insider trading and anti-fraud provisions in association with the establishment of an independent state agency charged with supervising securities markets. He proposes that securities regulation will promote good corporate governance among participants and the subsequent development of capital markets.²⁷⁰ An empirical study supports Coffee’s proposition, finding that improved disclosure regulations have the effect of reducing firms’ costs of capital and hence increasing efficiency within the economy.²⁷¹

Pistor takes the discussion a step further by proposing a new paradigm to explain the impact of law through finance, including, for the first time, trading rules.²⁷² These are rules which ‘establish the procedure by which property rights in firms can be traded, and *they determine who may trade on the exchange*’.²⁷³ She

²⁶⁸ John Coffee, ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’ (1999) 93 Nw. UL Rev. 641

²⁶⁹ Ibid

²⁷⁰ Similar argument is available at Bernard Black, The Legal and Institutional Preconditions for Strong Securities Markets. As published in UCLA Law Review, Vol. 48, pp. 781-855, 2001. Available at SSRN: <http://ssrn.com/abstract=182169> or <http://dx.doi.org/10.2139/ssrn.182169>

²⁷¹ Luzi Hail and Christian Leuz, ‘International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?’ (2006) 44 Journal of Accounting Research 485

²⁷² (Emphasis added) Pistor (n 24)

²⁷³ Ibid, 245

argues for a better understanding of the relationship between shareholder property rights, investor protection and trading rules by claiming that the law interacts with two models of ownership which differ from each other:²⁷⁴ (1) concentrated ownership, which mainly involves a conflict between minority shareholders and the controlling shareholder(s); and (2) dispersed ownership, which mainly involves conflicts between shareholders and managements.

Pistor claims that this new paradigm would eliminate the contradictions between the findings of La Porta et al. and Coffee's; whereas La Porta et. al. focus on shareholders' rules, which concern the allocation of property rights in the corporation; Coffee's focus is on rules which are not limited to existing shareholders but also potential ones, which can thus increase the attractiveness of investment in shares. Pistor proposes that the third set of rules – trading rules - should accommodate these conditions so that the kind of trading system is adopted which suits national conditions.²⁷⁵

Even though Pistor's argument is being open to criticism on the basis of her data and methodology,²⁷⁶ her analysis may be correct in that relationships among participants in secondary capital markets are regulated mostly by company legislation, and only partly by securities legislation. But from a secondary securities markets' perspective, her inclusion of trading rules in any explanatory theoretical framework for a securities markets law does not take into account the various needs of participants in secondary markets which are different from those in corporate governance. These different relationships entail differences in needs between: (i)

²⁷⁴ Ibid

²⁷⁵ Ibid. Pistor clearly prefers the path-dependent conclusion, which effectively means that she rejects Coffee's suggestion of functional convergence.

²⁷⁶ Strigham, Boettke and Clark (n 179)

issuers of securities and investors (Coffee) (ii) shareholders (or investors) and managements (La Porta et al. and Pistor), (iii) minority shareholders and controlling shareholders (La Porta et al. and Pistor), and (iv) shareholders (investors) and intermediaries (Pistor).

The existence of four different relationships demonstrates that there are three major drawbacks in Pistor's approach to analyzing trading rules. Firstly, Pistor's reliance on ownership structure with respect to trading rules will lead to the conclusion that legal systems will diverge rather than converge even functionally, since experience shows that corporate governance varies according to the political, economic, and cultural environments.²⁷⁷ It follows that listings in countries with different corporate governance regimes might fail since there would be a disconnection between the corporate governance with which the issuing company works and the trading rules that govern its shares. Empirical research, however, suggests otherwise; it is found that, as a sign of successful trading, liquidity increases in companies with controlling shareholders even when they are listed in foreign countries with different patterns of corporate governance.²⁷⁸ It should be emphasised that it is not argued here that corporate governance has no impact, because of course it does.²⁷⁹ But this does not mean that trading rules have to correspond to those suggested by Pistor.

Secondly, Pistor's account neglects the fact that there is a class of investors in secondary markets who trade there with the goal of making short-term profit by re-

²⁷⁷ Yuwa Wei, *Securities Markets and Corporate Governance: A Chinese Experience* (Ashgate Pub. 2009) 16

²⁷⁸ Meghana Ayyagari and Craig Doidge, 'Does Cross-Listing Facilitate Changes in Corporate Ownership and Control?' (2010) 34 *Journal of Banking and Finance* 208

²⁷⁹ By increasing the value of companies, for example. See Bernard Black, Hasung Jang and Woochan Kim, 'Does Corporate Governance Predict Firms' Market Values? Evidence From Korea' (2006) 22 *JLEO* 366

selling shares to others.²⁸⁰ Such trading in secondary markets for purposes other than investment is also important for economic development on the grounds of increased liquidity. Thus, Levine and Zervos suggest that it is stock market liquidity, rather than stock market size, that is correlated with economic growth.²⁸¹

Finally, the final group of relations – between investors and intermediaries - involves legal issues different from those suggested by the corporate governance literature. Essentially, such relationships rely on exchange transactions supported by the institution of law, including contracts and tort, rather than problems of agency arising from the separation of ownership and management.²⁸² These exchanges are concerned with the exploitative behaviour of the intermediaries who provide services.

In short, even Pistor's account does not fully or satisfactorily explain the requirements of the different relationships involved. What the foregoing discussion could suggest is that, for an efficient secondary market, the literature emphasises three sets of legal rules: corporate law, securities law, and trading law. Each branch of law deals with different type of relationships. It is the relationship between shareholders (investors) and intermediaries that investor protection in secondary markets is concerned with, and the literature is unclear as to how these type of rule should accommodate the legal context.

However, different types of misconduct arise for different reasons; for instance, takeover regulations aim to protect minority shareholders, whereas insider dealing arise from informational advantages as a result of an insider's ability to access certain information not available to the public. In line with the main argument of this

²⁸⁰ Ibid

²⁸¹ Levine and Zervos, 'Stock Markets, Banks, and Economic Growth' (1998) 88 *The American Economic Review* 537

²⁸² High Collins, *Regulating Contracts* (OUP 1999) 213

thesis, the ensuing discussion focuses mainly on the private enforcement of conduct of business regulations which aim to deter behaviour deemed misconduct or undesirable by a regulator in secondary securities markets. Accordingly, to be precise as to the subject, the discussion is elaborated to deal with the misconduct of service providers in secondary securities markets in relation to contracts aiming to transact for trading in secondary securities markets only.

As to the regulatory issues to be initially considered in the design of private enforcement frameworks, the next section discusses provide in detail what suitability and best executions as regulatory duties aim to achieve. Given the focus of this thesis on the conduct of service providers, namely stockbrokers and financial advisers, suitability and best execution are first identified as requirements promoted by IOSCO in order to enhance the integrity of markets.

This brings the discussion to the second requirement pointed out at the beginning of this section, which concerns the institutional design of the private enforcement of public law in terms of the characteristics of the potential private plaintiffs.

There are many different kinds of private parties in securities markets with different characteristics: regular investors, citizens, companies, investment firms, pensions funds, central banks and governments, for example. Thus, different frameworks may be needed to accommodate these different characteristics. However, in line with the comparative method of this thesis and with accepted standards as promoted by IOSCO, it could be argued there are two main classes of investors: unsophisticated or 'retail investors' and sophisticated investors. Such a categorisation is provided by the IOSCO as reflecting the most fundamental distinction between investors in securities markets.

Given the focus on retail investors, it is a question of their characteristics from a private enforcement perspective. Three problems have been identified with regard to private enforcement by retail investors: the latter are not aware of their position in law; the law itself is unclear as to the dispute; and there is a lack of incentive for retail investors to pursue a lawsuit.

To start with, a general feature of private law is that it is not self-implementing and, consequently, investors must take the initiative to enforce their legal rights since, presumably, their self-interest will lead them to take action against businesses which have infringed their legal rights.²⁸³ However, the applicability of the two premises under this statement, that investors know their rights and are sufficiently motivated to press them, are substantially reduced in financial markets in general, including securities markets.²⁸⁴ Many studies have reported that the willingness to sue of those who engage in financial markets is limited because they are unaware of the true position in law where they have a remedy against the wrong committed against them, or the law is not clear as to their cases.²⁸⁵

Moreover, it has been observed that retail investors may sometimes lack the economic incentive to exercise their legal rights, whether because of the high costs associated with enforcement or the low level of compensation likely to be awarded.²⁸⁶ It is argued that one of the reasons for the high costs associated with litigations related to financial services is the need to link market standards to the quality provided to the

²⁸³ Colin Scott, Julia Black and Ross Cranston, *Cranston's Consumers and the Law*, (Butterworths 2000) 102

²⁸⁴ Dan Coates and Steven Penrod, 'Social Psychology and the Emergence of Disputes' (1980) 15 *Law & Soc'y Rev.* 658; Fredrick Dunbar and Faten Sabry, 'The Propensity To Sue: Why Do People Seek Legal Actions?' (2007) 42 *Bus. Econ.* 31; Jennifer Earl, 'When bad things happen: Toward a sociology of troubles' ch. in Rebecca Sandefur (edt), *Access to Justice* (Emerald 2009)

²⁸⁵ Cartwright (n 198) 80; Gordon Borrie, *The Development of Consumer Law and Policy: Bold Spirits and Timorous Souls* (Stevens & Sons 1984) 337

²⁸⁶ *Ibid*

complainant, which requires expert evidence.²⁸⁷ In such a case, average (mainly retail) investors are at a disadvantage - particularly with small claims – because, firstly, experts are expensive to employ²⁸⁸ and, secondly, under some legal systems the plaintiff has to bear the costs.²⁸⁹ Furthermore, other procedures associated with enforcement could increase the cost of enforcement to such an extent that investors may give up on enforcing their rights even after obtaining a judgement. Studies have found that the time and costs associated with enforcement are evidently burdensome in some legal systems; for example, a British study shows that a substantial number of litigants in small claims abandoned enforcing their judgements because of the costs associated with such enforcement.²⁹⁰

Consequently, it is possible to suggest that, as far as the characteristics of retail investors are concerned, their powers for the private enforcement of the law of securities markets are affected, or rather impaired, by their lack of awareness of their position in law. Furthermore, the law itself is unclear as to the dispute, and there is a lack of incentive for retail investors to pursue lawsuits. Such factors, accordingly, should be taken into account in the institutional design of the private enforcement of regulations which protect retail investors.

The last consideration in deciding whether or not to provide for private enforcement is its effect on public enforcement efforts. It would be unrealistic to generalise as to this effect because of the complexity associated with the different kinds of public enforcement strategies; be these prosecutions, administrative sanctions, or processes of persuasion, negotiation, advice, education, or promotion.

²⁸⁷ See Iain Ramsay, 'Framework for Regulation of the Consumer Marketplace' (1985) 8 J. Cons. Pol. 353

²⁸⁸ Scott, Black and Cranston (n 283) 108-110 ; Vidmar (n 257)

²⁸⁹ Donald Abraham, 'Investor-Financed Lawsuits: A Proposal to Remove Two Barriers to an Alternative Form of Litigation Financing' (1992) 43 Syracuse L. Rev. 1297, 1299

²⁹⁰ Tamara Relis, 'Civil Litigation From Litigants' Perspectives: What We Know and What We Don't Know About the Litigation Experience of Individual Litigants' (2002) 25 Stud Law Polit Soc. 151, 191

But in general, there are two broad categories of enforcement style: a ‘compliance’ approach, which emphasises the use of measures falling short of prosecution in order to encourage compliance with regulations; and ‘deterrence’ approaches, which are penal and use prosecution in order to deter future infractions. Whether the style is a matter of choice by policymakers is still debatable. For example, it has been suggested that the American system of enforcement tends to be more litigious, adversarial, and deterrence-based than the more compliance-oriented British approach. However, Baldwin et al. argue that such categories, deterrence versus compliance, do not fit new theories of enforcement style of a regulator and subsequent compliance by regulatees. Current well-established theories of ‘responsive regulations’ and ‘smart regulations’ have resulted in more attention to motivation and behaviour, and to ‘risk-based regulations’ and a ‘principles-based’ approach to regulatory enforcement.²⁹¹

This complexity has two implications: first, any evaluation of public enforcement with private enforcement in mind has now become a more country-specific issue;²⁹² and, second, there is little research as to what the optimal role for private enforcement might be among the different enforcement strategies. For these reasons, as well as the comparative method used in this thesis, less emphasis is placed upon enforcement strategies and more focus is placed on the institutional design of private enforcement of regulations in the UK and Saudi Arabia.

E) Concluding Remark

This section builds upon the previous discussion where it was claimed that a securities market is any organised process in an identifiable location or system through which financial contracts or claims which represent obligations or rights that have their own

²⁹¹ Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (OUP 2012) 9

²⁹² See for example Rüdiger Veil, ‘Enforcement of Capital Markets Law in Europe – Observations from a Civil Law Country’ (2010) 11 E.B.O.R 409

value and are transferable are exchanged, issued and traded. It was noted that there are different types of securities markets but that the focus of this inquiry is mainly on capital markets, which include stock, bonds, and derivatives markets. It was also pointed out that secondary markets play an important role in enhancing confidence in primary markets, as well as providing prices that can be utilized to guide the process of the allocation of capital and wealth.

The previous sections in this part have presented views of what is deemed important by international organisations with respect to the investor protection provided in secondary capital market regulations, and the conceptual framework for securities markets regulations supported by evidence is proposed. It is demonstrated that there is still disagreement among scholars as to what legal rules are important for a well-functioning secondary capital market. Generally, this chapter identifies three areas of law: (1) corporate law; (2) securities law; and (3) trading law. It is argued that none of these three areas alone is capable of satisfying the needs associated with the different relationships which are identified to exist in secondary securities markets. Nevertheless, as far as trading is concerned, it is pointed out that many company shares are able to enjoy a high level of liquidity and trading even though they are listed in countries with legal systems that have characteristics of corporate law different from those in their home countries. Accordingly, it could be suggested that there is no connection between trading rules and corporate law.

Such a suggestion resolves a well-known subject of debate among comparative legal scholars that convergence between legal systems which belong to different legal families, for instance those based on common or civil law, is likely to

be difficult because of irreconcilable theoretical differences between them.²⁹³ Moreover, it supports attempts by international organisations to propose regulations based on experience in common-law countries among other countries from different legal families.

It is pointed out that, whereas public enforcement is necessary for securities markets, it is arguably accurate that securities markets are better off with private enforcement because: (1) the latter provides additional resources for enforcement, (2) it makes up for lax enforcement by public agencies, and (3) it helps in clarifying the law. However, given the lack of an optimal framework for private enforcement of securities markets regulations within a regulatory regime, reference to the literature on the private enforcement of public regulations suggests three criteria for designing an effective framework: (a) context-specific information about the regulatory problem; (b) the characteristics of potential private plaintiffs; and (c) the effect of private enforcement on public enforcement efforts.

As to the regulatory problem, it is pointed out that conduct of business regulations are claimed to be one of the three underlying rationale for regulations in securities markets. Overall, as pointed out by Llewellyn, conduct of business regulation ‘is designed to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers.’²⁹⁴ This category of regulations deals mainly with unfair practices between financial institutions and participants, but it may also include dealing with conflicts of interest, disclosure issues, competition issues, and anti-money laundering rules. Accordingly, given the diversity of regulatory problems dealt with in conduct of business regulations, it is argued that additional

²⁹³ For more discussion, see Athanassios Yiannopoulos, ‘Brokerage, Mandate, and Agency in Louisiana: Civilian Tradition and Modern Practice’ (1959) 19 La. L. Rev. 777

²⁹⁴ David Llewellyn, ‘The Economic Rationale for Financial Regulation’ (n 200)

precision is needed for the specific problem that a particular rule aims to promote. Thus, Part III spells out in more details the regulatory issue of standards of conduct of service providers providing financial services to retail investor in secondary markets subject to suitability and best execution rules.

As to the characteristics of potential plaintiffs, it is argued that empirical research suggests that enforcement by retail investors is impaired by their lack of awareness of their position in law, the law itself being unclear as to the dispute, and the lack of incentive for retail investors to pursue lawsuits. It is, therefore, important to take into account these problems in designing effective frameworks for private enforcement of secondary securities markets regulations.

Finally, it is very difficult to generalise on the effect of private enforcement on public enforcement due to the availability of different kinds of public enforcement strategy. It is argued that such an analysis should be country-specific given that it is unclear what the impact of private enforcement is within each of these strategies, and in addition an overall theoretical explanation that links the role of private enforcement to regulatory strategy is lacking.

The next part builds upon the argument provided in Part II by investigating the regulatory problems that suitability and best execution as regulatory duties aim to resolve. This is followed by the conclusion part to bring together the whole discussion so far.

Part II The Regulatory Duties on Stockbrokers of Best Execution and Suitability

A) The Role of Stockbrokers as Intermediaries

When talking about capital markets, special references is made to stocks and stockbrokers because the history of these markets, and securities markets in general, is closely associated with the evolution of stock markets.²⁹⁵ Evidently, stock markets have been in existence for a long time. In the seventeenth century, shares in public companies became very attractive and were sold by Dutch, French and English companies to people in their countries.²⁹⁶ Stockbrokers were deemed important because they worked as intermediaries ‘who arrange on behalf of private investors the sale and purchase of shares’.²⁹⁷ In England, company shares were sold and traded at the Royal Exchange and in coffeehouses by agents of investors, and this activity is considered the first expression of specialized jobbers and brokers.²⁹⁸

In well-functioning stock markets, it has long been considered that a broker or brokerage firm should exercise care and demonstrate a reasonable level of skill in accordance with reasonable practice in the brokerage business.²⁹⁹ It is for this reason, it is claimed, that stock exchanges were established; to restrict entrance to stock exchanges to brokers in order to ensure the conduct of its members and to limit

²⁹⁵ K.G. Davis, ‘Joint-Stock Investment in the Later Seventeenth Century’ (1952) 4 *Econ. Hist. Rev.* 293, 287; Skand Chaturvedi, *Financial Management: Entailing Planning for the Future*, (Global India Publ. 2009) 11

²⁹⁶ Davis, *Ibid*

²⁹⁷ Ralph Tench and Liz Yeomans, *Exploring Public Relations* (2nd ed., FT Prentice Hall 2009) 467

²⁹⁸ Edward Morgan and William Thomas, *Stock Exchange: Its History and Function* (Elek Books Limited 1969) 14 -17

²⁹⁹ R.S. Bhatia, *Encyclopaedia of Investment Management* (Anmol Publications 2000) 74; Massimo Cirasino and others, *Payments and Securities Settlement Systems in Latin America* (World Bank 2006) 240

fraudulent practices.³⁰⁰ Accordingly, it could be argued that the conduct of brokers can affect the health of stock markets.

In the twenty-first century brokers are just as important for the functioning of capital markets as they always were in acting as intermediaries between sellers and buyers. The role of brokers has been extended from the execution of their customers' orders to performing other services for them such as clearing, custody and settlement services.³⁰¹ It should be noted that investment and merchant banks also work as intermediaries to arrange the sale and purchase of stocks and other securities, but they work mainly with institutional investors and financial institutions.³⁰²

While the important role of brokers could be highlighted in theory, in practice it is evident that stockbrokers have various roles depending on the structure of the markets in which they work. Three broad forms of the structure for secondary securities markets have been identified: brokers-markets, dealers-markets and auction-markets. In each form, brokers play different roles in facilitating the functioning of these markets.

The first form of structure of secondary capital markets is the auction markets, of which there are two kinds: call auctions where brokers meet at a specific time such as in gold markets; or continuous auctions which offer trading throughout the day such as with shares on the New York Stock Exchange (NYSE). The distinctive feature of an auction market is that orders are centralized, and thus the highest bidder

³⁰⁰ William Antwerp, *The Stock Exchange From Within* (1st published in 1913, Arno Press, 1975) 20

³⁰¹ Given their central role, it is claimed that brokers 'handle and control the life blood of the Capitalism system' in Daniel Montano, *The Twenty-First Century Stockbroker: A New Wave* (Montano1993) 19. For more details as to the role of brokers in modern markets see Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (OUP 2003) ch 7

³⁰² Larry Harris, *Ibid*

and the lowest offer are exposed to each other.³⁰³ In this type of secondary market the broker serves as a recorder or an auctioneer of the interests of buyers and sellers.³⁰⁴

Secondly, a secondary securities market could tend to take the form of a brokered market if there was a lack of sufficient participants to deal with each other at the same time.³⁰⁵ In a brokered market buyers and sellers employ a broker to search for the other side of the deal in exchange for a commission.³⁰⁶ Certain derivatives markets that are OTC or off-exchange are brokered markets. Here, the behaviour of brokers is more important compared to these in auction markets, because they maintain a high degree of influence and are aware of the trading and prices of securities executed where there is no public transparency.

Finally, dealer markets exist where there are rapid shifts in the movement of prices. This makes it profitable to remain in the market to serve as a counterparty while brokers are still searching for sellers or buyers.³⁰⁷ A dealer or a jobber, thus, buys for herself when people are selling and sells when people are buying. Dealer markets can exist in either brokered markets or auction markets. The United States government bonds and equities are examples of auction markets, whereas bonds traded off-exchange are examples of dealers markets existing in brokered markets.

Moreover, it is possible for a certain market to exhibit the characteristics of two types. The NYSE market, for example, shifts to being a dealers market when

³⁰³ Other examples include auctions for new government debt, such as British gilt and U.S. Treasury Bills. For more details see Roy Bailey, *The Economics of Financial Markets* (CUP 2005) 38

³⁰⁴ Ibid

³⁰⁵ Laura Beny, 'US Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition' (2002) 2002 Colum. Bus. L. Rev. 399

³⁰⁶ Ibid

³⁰⁷ Ibid

there is insufficient public demand or offers. In this case, brokers are part auctioneers and part dealers.³⁰⁸

However, looking at brokerage from a business services perspective rather than as part of the market structure appears to raise different legal issues. Essentially, it has been argued that as a result of globalization and de-regulation, investment banking including brokerage, has merged with other banking activities and is being provided with other financial services by the same institution.

Such business practice of brokerage business has in the last thirty years shifted its business model. Previously, for years if not centuries, charging commission for each transaction was the most common, if not the only practice enabling profit to be made from providing brokerage services. Currently, it is argued that the business model adopted by most, but not all, financial institutions has shifted to charging fees based on the volume of assets under management.³⁰⁹

Such a change in business model has resulted in two major developments in practice. Firstly, from an investor's perspective, the investor is better off increasing the volume of trading;³¹⁰ since the more trade which is executed, the less costly the charges become. Secondly, brokers have become more aggressive in marketing other services in order to generate additional income.³¹¹ In doing so, brokers and brokerage institutions may encourage their customers to amend their investment strategies or adopt a strategy that would bring more benefit to the brokers, but at the same time

³⁰⁸ Ibid; Spencer (n 140) 80

³⁰⁹ Ingo Walter, 'Conflicts of Interest and Market Discipline Among Financial Service Firms' (2004) 22 *European Management Journal* 361. Note that the commission-base model still exists especially in retail markets.

³¹⁰ See Claudio Salini, 'Recent Evolution in Securities Market Price Formation Mechanisms' (IOSCO Conference, Amman, 2004) <http://www.iosco.org/library/annual_conferences/pdf/ac18-14.pdf> accessed 29 June 2011

³¹¹ Ingo Walter (n 309)

exposing the customers to additional risks, such as in stock lending and margin financing.

Despite the significance and importance of the topic, there has been little empirical research into how such a change in business model may increase the exposure of stockbrokers to regulatory risks. A similarly neglected more fundamental question is whether or not the legal solutions which have evolved throughout history are still appropriate in dealing with brokerage service given the change in business model.

For example, a broker may be encouraged by a firm's compensation arrangements to sell in-house products as opposed to other products that would better suit the client's needs,³¹² or a broker may inadequately assess the customer's attitude towards risks.³¹³ It is one thing to say that brokers are selling services and products aggressively, but it is quite a different thing to state that brokers provide inappropriate advice to their customers. The difference between them is critical from an economic point of view; an intermediary with no direct selling or buying interests will use her experience and skills to filter out bad items and provide the investor with the best available products in the market,³¹⁴ thus guiding demand to the most efficient and most needed financial products.³¹⁵

³¹² Ibid

³¹³ In a recent survey about stockbrokers in retail markets in Australia, it has been found that stockbrokers overestimate their customers' attitude to risk when brokers are giving advice, see Marilyn Clark-Murphy and Geoffrey Soutar, 'Do Retail Stockbrokers Understand Clients' Investment Preferences?' (2008) 13 J.F.S.M. 135

³¹⁴ Spencer (n 140); John Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 Va.L.Rev. 717, 753; William Whitford, 'The Function of Disclosure Regulation in Consumer Transactions' (1973) Wis.L.Rev. 400; Isaac Alfon, 'An Additional Perspective for Retail Financial Products and their Regulation' (2004) a paper presented in the FSA conference <http://www.fsa.gov.uk/pubs/consumer-research/rfp_paper.pdf> accessed 29 June 2011

³¹⁵ Sally McKechnie, 'Consumer Buying Behaviour in Financial Services: An Overview' (1992) 10 International Journal of Bank Marketing 5

In short, brokers in general, and stockbrokers in particular, play an important role in the functioning of secondary securities markets. This role will be determined to a great extent by the structure of the market itself. It is also clear that the globalisation and deregulation of financial markets and services as well as the change in the business model of brokerage businesses are likely to have created an incentive for brokers to mis-sell financial services and products to their customers, which may negatively affect the efficiency of the distributional process in financial markets in general and securities markets in particular. The discussion so far draws attention to the importance of evaluating common legal resolutions in relation to the brokerage business, and to question the need for revising some of these legal assumptions.

B) IOSCO's Principles Concerning the Conduct of Intermediaries

The increased globalization of securities markets and markets for capital renders the role of international organisations more critical for their effective and efficient function.³¹⁶ These organisations are important as a forum in which professionals exchange experience and transfer knowledge about how to attract and deal with international funds and finance.

The international organisations that deal with financial markets issues can be classified into three groups depending on their functions. Firstly, there are organisations which promote broad policy agendas relevant to capital markets, such as the liberalisation of financial markets. Examples are the WTO, International Monetary Fund, Organisation for Economic Co-operation and Development (OECD) and the World Bank. Secondly, some private international organisations enjoy the

³¹⁶ Dominik Egli, 'How Global Are Global Financial Markets? The Impact of Country Risk' (2000) a paper presented in International Financial Markets and The Implications for Monetary and Financial Stability, BIS Conference Papers No. 8, <<http://www.bis.org/publ/confer08.htm>> accessed 29 June 2011

power to create *de facto* soft laws, since they either influence the behaviour of participants in financial markets, or reference to their publications represent accepted international standards. Examples are credit rating agencies, the International Centre for Financial Regulation (ICFR) and the International Swap and Derivatives Association (ISDA).³¹⁷

Lastly, there are officially recognised international organisations which do not exercise legal authority but do enjoy powers to set standards for national regulation and supervision which could be seen as the parameters within which national systems formally operate. This group includes the Basel Committee, BIS, the Financial Stability Board, and IOSCO.

As far as the institutional design of regulatory regimes for securities markets is concerned, it could be argued that the most influential organisation is the IOSCO. Whereas it started with a membership of 40 countries in the 1970s,³¹⁸ IOSCO currently pronounces that its 'wide membership regulates more than 90% of the world's securities markets', and asserts that its members 'regulate more than one hundred jurisdictions'.³¹⁹

Those members have endorsed IOSCO's principal document, the 'Objectives and Principles of Securities Regulation', and expressed their commitment to the objectives and principles in the document: '[i]nsofar as it is within their authority, they intend to use their best endeavors within their jurisdiction to ensure adherence to those principles. To the extent that current legislation, policy or regulatory arrangements may impede adherence to these principles, they intend that changes

³¹⁷ For more information see the organisation website at <www.isda.org/> accessed 29 June 2011

³¹⁸ Lewis Solomon and Louise Corso, 'The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation' (1990) 24 J. Marshall L. Rev. 299, 333

³¹⁹ IOSCO, 'Objectives and Principles of Securities Regulation' (n 89) 1

should be sought'.³²⁰ In addition to its recognition by many countries, influential international organisations such as the IMF and Financial Stability Forum recognise the IOSCO document as representing the 'key global standards of securities regulation'.³²¹

Therefore, it is possible to argue that, given its wide recognition, IOSCO could be seen as the international standards agency whose rules all countries are bound to follow, including Saudi Arabia and the UK. The UK is an ordinary member of IOSCO through the membership of the FSA, and in addition the London Stock Exchange is an affiliate member.³²² In the same vein, Saudi Arabia became a member of IOSCO in June 2010.³²³

Accordingly, it could be claimed that the fact that both the UK and Saudi Arabia are members of the IOSCO means that both case study countries are bound by the IOSCO document.

Having said that, it could also be suggested that the IOSCO document has been successful in establishing a universal, clear and comprehensive list of objectives in respect of capital and securities markets. The 'Objectives and Principles of Securities Regulation' states that there are three principal objectives for effective securities regulation: (i) to secure the protection of investors; (ii) to secure the integrity of markets in the sense that they embrace fairness, and: (iii) the need to

³²⁰ Ibid, 3; also see IOSCO Resolution No. 41, 'Resolution on IOSCO Adoption of the Objectives and Principles of Securities Regulation (P.C.)' (September 1998), <<http://www.iosco.org/library/resolutions/pdf/IOSCORES16.pdf>> accessed 29 June 2011

³²¹ The World Bank and IMF, *Financial Sector Assessment: A Handbook*, (World Bank and International Monetary Fund 2005) 140

³²² A list of all members of IOSCO is available on the internet at: https://www.iosco.org/lists/display_members.cfm?CurrentPage=11&orderBy=jurSortName&alpha=No ne&memID=1&rows=10 accessed 29 June 2011

³²³ IOSCO, 'IOSCO Expands Its Global Membership to Include Iceland, the Maldives, Saudi Arabia and Syria' (June 2010), IOSCO News Release, < <http://www.iosco2010.com/pdf/com09juin2010-2.pdf>> accessed 29 June 2011

reduce systemic risk.³²⁴ Consequently, it could be maintained that investor protection, market integrity through fairness and reducing systemic risks are the three principal objectives for securities regimes within our case studies as well as in hundreds of other jurisdictions. It is the objective of investor protection with which this thesis is concerned.

The IOSCO document spells out the protection of investors from ‘misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets’.³²⁵ The IOSCO has specified 38 principles to give these three objectives ‘practical effect’,³²⁶ which are categorised into nine groups:³²⁷ (1) principles relating to the regulator; (2) principles for self-regulation; (3) principles for the enforcement of securities regulation; (4) principles for cooperation in regulation; (5) principles for issuers; (6) principles for auditors, credit rating agencies, and other information providers; (7) principles for collective investment schemes; (8) principles for market intermediaries; and (9) principles for secondary markets. The IOSCO recommends different regulatory techniques for implementing these principles, including: disclosure, authorizing participants, intermediaries and providers, supervision, regulatory enforcement, access to courts as a means of redress, and cooperation with other regulators.³²⁸

Given that the focus of this thesis is secondary capital markets, it could be suggested that the IOSCO document encourages the protection of investors against misleading conduct, misbehaviour and abuse carried out in secondary capital markets.

Here, group 8 of the IOSCO principles, which concerns principles dealing with

³²⁴ IOSCO, ‘Objectives and Principles of Securities Regulation’ (2010), <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>> accessed 29 June 2011

³²⁵ IOSCO, ‘Objectives and Principles of Securities Regulation’ (May 2003) (n 89) 5

³²⁶ The World Bank and IMF (n 321) 140

³²⁷ In the publication of 2003 there were 30 principles and section. IOSCO introduced section F after the initial publication of the document.

³²⁸ Ibid

market intermediaries, is of relevance to the inquiry in this research, and, therefore, is addressed in this section in detail.³²⁹ This group includes principles 31-34, specified as follows:

Principle 31: ‘Regulation should provide for minimum entry standards for market intermediaries’;

Principle 32: ‘There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake’;

Principle 33: ‘Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters’; and

Principle 34: ‘There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk’.

Whereas principles 31 and 32 deal with market entry and the prudential regulations of intermediaries respectively, and principle 34 is clearly concerned with

³²⁹ This group of principles are headed with letter H in IOSCO documents. Note that section ‘I’ headed “secondary markets” but it focuses on the structuring of secondary markets rather than substantive regulations. Section I involves four principles that state:

33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight

34. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

35. Regulation should promote transparency of trading

36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.

37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

38. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

systemic risk, it could be suggested that only principle 33 is related to the conduct of intermediaries which is the main focus of the current study.

A careful reading of principle 33 supports the view that its main focus is the conduct of intermediaries. In addition to emphasising that operational conduct should aim to protect the interest of the client, it should be pointed out that the management of risk includes risks associated with the conduct of intermediaries. In the IOSCO document, the risk mentioned in principle 33 refers to intermediaries' capital, client money and market confidence that could result from the conduct of intermediaries.³³⁰ According to IOSCO, market confidence risks include *inter alia* a failure of due execution or inadequate advice, the misuse of the client's instructions for the benefit of intermediaries, 'manipulation and other trading irregularities, or fraud on the part of the intermediary or its employees'.³³¹

In the view of IOSCO, in order to contain such risk, a regulatory regime should ensure that intermediaries are required to 'conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the market ... [by] ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm'.³³² For example, where a financial advisory service is provided,³³³ a regulator should ensure that advisors are licensed, keep records, ensure adequate disclosure to the client, and introduce rules and procedures covering 'guarantees of future investment performance, misuse of client assets, and potential conflicts of interest'.³³⁴

³³⁰ IOSCO, 'Objectives and Principles of Securities Regulation' (n 89) 32

³³¹ Ibid, 33

³³² Ibid, 35

³³³ 'Investment advisers are those principally engaged in the business of advising others regarding the value of securities or the advisability of investing in, purchasing or selling securities', Ibid, 38

³³⁴ Ibid, 39

The IOSCO recommends different regulatory initiatives to control the conduct of financial advisers, including substantive obligations such as the suitability of advice provided and ensuring that an investor or a customer is aware of the risk associated with a recommended investment.

However, it could be noted that, throughout its documents as to the conduct of intermediaries IOSCO recommendations focus mainly on retail clients. For instance, the regulatory requirement of suitability, which imposes an obligation upon the adviser that his or her advice ‘matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience’,³³⁵ is recommended to be applied to retail customers only who, accepting differences among jurisdictions, are investors other than those normally referred to as ‘professional,’ ‘qualified’ or ‘sophisticated’ investors.³³⁶

Such a perception of retail customers suggests that this type of investor is not determined by specific criteria so much as by excluding other types of investors who are not eligible for the added protection provided by a regulatory regime. Consequently, it could be suggested that the lack of rationale or criteria from the IOSCO with regards to ‘retail investors’ is more likely to result in the existence of more than one perception of the concept of ‘retail investors’ in different jurisdictions.

Accordingly, a suggestion made in this thesis is that, as far as secondary markets are concerned, it seems likely that countries will differ in their implementation and hence in the outcome of regulatory protection because of the deeper underlying differences in their perceptions of the ‘retail investor’.

³³⁵ IOSCO, ‘Customer Suitability in the Retail Sale of Financial Products and Services’ (2008) The Joint Forum, <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD268.pdf>> accessed 29 June 2011. Note that the document defines mis-selling as ‘the situation where the firm sells a product to a client that is not suitable for that client, whether or not a recommendation is made’.

³³⁶ IOSCO, ‘Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds’ (Report of the Technical Committee of the IOSCO, 2003) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD142.pdf>> accessed 29 June 2011

Lack of clarity is also evident in specifying what appropriate regulatory duties in monitoring conduct or misconduct should be regulated, spelled out, enforced and complied with. However, by reading the different documents, it is possible to compile a short list of principles, which include suitability, conflicts of interest and disclosure, among others. The documents provide no detail as to what these principles entail. Moreover, the absence of reference to private enforcement leaves countries with no option but to pursue their own choices as to an institutional design for it; that is, if policymakers decide to include private enforcement within their regime.

The absence of such clarity accordingly requires an investigation as to why these regulatory duties have been developed, what they facilitate in securities markets, and how they relate to the wider social welfare. The following two sections thus examine the development of suitability and best execution as regulatory duties as well as the justifications for introducing them into modern securities markets regulations.

C) The Regulatory Requirement of Suitability

The word ‘suitability’ in ordinary language means being ‘right or appropriate for a particular person, purpose, or situation’³³⁷ or ‘acceptable or right for someone or something’.³³⁸ The term has acquired a more specific meaning within financial services and markets referring to the ‘requirement that any investing strategy falls within the financial means and investment objectives of an investor or trader’.³³⁹ From a policymaking perspective, there is a specific conception as to the meaning of suitability, which can be said to be ‘a policy judgement that investors should neither

³³⁷ Oxford Dictionary Online <<http://oxforddictionaries.com/>> accessed 29 June 2011

³³⁸ Cambridge Dictionary Online <<http://dictionary.cambridge.org/>> accessed 29 June 2011

³³⁹ The Options Industry Council, Glossary, <<http://www.optionseducation.org/help/glossary/default.jsp?letter=S>> accessed 29 June 2011

be encouraged nor permitted to invest outside their tolerance of risk'.³⁴⁰ This section attempts to demonstrate the importance of suitability in modern financial markets and links this to the public interest in regulating financial markets in general and securities markets in particular.

The historical development of the requirement of 'suitability' is important in determining the context and expected benefits of imposing such a requirement. Even though securities regulations have existed in the US since the 1920s, the regulatory duty of suitability did not emerge until the 1960s.³⁴¹ In the time between the introduction of securities regulations and the recognition of suitability as a regulatory duty, suitability was imposed through the NYSE as a sub-rule of the exchange's duty of 'know your customer' and in the National Association of Securities Dealers (NASD) under the association rule of 'Fair Trading'.³⁴²

Interestingly, while it is suggested that suitability evolved as a response to high pressure selling by stockbrokers through long-distance telephone calls, known as the 'boiler room',³⁴³ it should be emphasised that it was the American courts rather than the exchanges which successfully articulated such a duty. In response to boiler room activities that involved misrepresentation and gross overreach, the courts recognised suitability to be a private cause of action for investors on the basis that it constituted a violation of Rule 10b-5 which deals with fraud or deceit.³⁴⁴ From different cases brought before the courts, a general notion developed that 'a security

³⁴⁰ Harvey Bines and Steve Thel, *Investment Management Law and Regulation* (Aspen 2004) 176-186.

³⁴¹ Frederick Gedicks, 'Suitability Claims and Purchases of Unrecommended Securities: a Theory of Broker-Dealer' (2005) 37 *Ariz. St. L.J.* 535, 543

³⁴² NYSE rule 405(1) and NASD Rules for Fair Trading, Article III, s.2(a) cited in Lyle Roberts, 'Suitability Claims under Rule 10b-5: Are Public Entities Sophisticated Enough to Use Derivatives' (1996) 63 *U. Chi. L. Rev.* 801, 808

³⁴³ For detailed discussion, see Loss and Seligman (n 121) 1084-1088

³⁴⁴ SEC Rule 10b-5 prohibits and gives a cause of action for any acts or omissions resulting in fraud or deceit in connection with the purchase or sale of any security.

being sold must reasonably fit the requirements of the person being solicited'.³⁴⁵ Subsequently, the SEC in 1967 promulgated a general suitability rule, Rule 15b 10-3, which was applicable to brokers who were not member of NASD.³⁴⁶ It could be suggested, thus, that this date marks the beginning of suitability as a regulatory duty.

As a regulatory rule, it is thought that the concept of 'suitability' was developed in order to impose two distinct kinds of duties upon advisers in the US: 1) suitability as to specific customer needs and requirements, and; (2) the suitability of a financial product to be a 'suitable investment' upon a reasonable basis, known as 'reasonable-basis suitability'.³⁴⁷

As to the customer's need in category (1), there is agreement that advisers are under a duty to collect sufficient information about their customers to enable them to make informed judgements about the suitability of financial products or securities . For example, the NASD requires that:

'any recommendation a broker makes to a non-institutional customer be supported by a reasonable belief that the recommendation is 'suitable' for the customer, and requiring ... the broker [to] obtain information about the customer's financial and tax status, his or her investment objectives, and such other information used or considered to be reasonable ... in making recommendations to the customer'.³⁴⁸

In contrast, reasonable-basis suitability requires that 'broker-dealers have a reasonable belief that the securities they recommend are suitable *for somebody*'.³⁴⁹ This dimension of suitability imposes on an adviser the requirement to look at the security or the product objectively without reference to the customer's needs or

³⁴⁵ Bines and Thel (n 340) 168-169

³⁴⁶ Ibid

³⁴⁷ Loss and Seligman (n 121)

³⁴⁸ NASD Manual, 2310. Similarly, see the New York Stock Exchange's suitability rule – Rule 405

³⁴⁹ [original emphasis], Gedicks (n 341) 549

objectives. An example of a breach of this requirement of suitability is to recommend a share in a ‘thinly traded shell corporation with no operations, earnings, or assets’.³⁵⁰

The economic importance of suitability, as demonstrated by its historical development, could be linked to the importance of financial advice in improving efficiency. Generally, two broad themes of economic analysis of the relationship between economic efficiency, regulations and investor protection can be identified. Briefly, one theme of economic models focuses on the supply of capital as a government rationale for intervention. The premise here is that, by increasing the engagement of agents (investors) within an economy, the cost of finance within the whole economy will decrease because of the increased supply provided by new investors. The second theme of economic models focuses on reducing the uncertainty around transacting in financial markets, so that the costs of transactions will eventually decrease. As a service, financial advice guides investors to the optimal choice of asset allocations within an economy by matching their needs to the assets that most satisfy them.³⁵¹ At an individual level,³⁵² financial advice is of benefit too in helping individuals to find the appropriate products without the need to spend too much effort and time on the purchase of something once in a lifetime.³⁵⁴

Moreover, any reliance on the rationality of investors in correcting information asymmetry in financial markets has been proven to be inefficient at best and ineffective at worst.³⁵⁶ The underlying assumptions behind disclosure requirements, concerning the rationality of investors and their ability to interpret

³⁵⁰ Ibid

³⁵¹ Roman Inderst and Marco Ottaviani, ‘Consumer Protection in Markets with Advice’ (2010) 6 Competition Policy International 49

³⁵² Ralph Bluethgen and others, ‘Financial Advice and Individual Investors’ Portfolios’ (SSRN, March 2008) <<http://ssrn.com/abstract=968197>> accessed 29 June 2011

³⁵⁴ Ibid

³⁵⁶ Page and Ferguson (n 105) 48; Michael Foot, ‘Working with market forces’ in Paul Mizen (ed.) *Monetary History, Exchange Rates and Financial Markets* (Edward Elgar 2003)

financial documents, are not always applicable, especially where unsophisticated investors are involved.³⁵⁷ Benjamin argues that the recent excessive development of disclosure requirements amount to a “distortion”, since no amount of disclosure would ever be enough for truly informed consent.³⁵⁸ Empirical research shows that excessive information provided to investors can cause confusion and may eventually discourage them from engaging and purchasing financial instruments.³⁵⁹

Therefore, it could be expected that inadequate financial advice would lead to losses in the welfare of society in terms of the misallocation of resources.³⁶⁰ It is for this reason that it is argued that suitability helps in increasing investor confidence through the knowledge that no unsuitable advice will be provided.³⁶¹ Accordingly, it could be argued that suitability is an important regulatory duty since it increases not only the efficiency of the economy by ensuring the quality of advisory services, but also the confidence of investors that they will receive suitable advice.

However, it should be emphasised that suitability was not the only regulatory response developed in response to financial advisers not always providing adequate advice and exploiting their customers.³⁶² To ensure the adequacy of financial advice, general policies have been implemented through regulations which can be categorised under three general groups: (1) those aiming to reduce the need for financial advice, for instance increasing the investor’s knowledge or reducing the complexity of products; (2) those ensuring the quality of advice, such as risk warning; and (3) those

³⁵⁷ Russell Korobkin, ‘Bounded Rationality, Standard Form Contracts, and Unconscionability’ (2003) 70 U Chi L Rev. 1203

³⁵⁸ Joanna Benjamin, *Financial Law* (OUP 2007) para 25.34; Stephen Choi, ‘Regulating Investors Not Issuers: A Market-Based Proposal’ (2000) 88 CLR 279, 334

³⁵⁹ Peter Lunt, Sonia Livingstone and Tanika Kelay, ‘Risk and Regulation in Financial Services and Communications’ (Social Contexts and Responses to Risk Network, paper no. 990, London School of Economics, 2005) <<http://eprints.lse.ac.uk/990/>> accessed 29 June 2011

³⁶⁰ Rene Fischer and Ralf Gerhardt, ‘Investment Mistakes of Individual Investors and the Impact of Financial Advice’ (the 20th Australasian Finance and Banking Conference, 2007) 18, <<http://ssrn.com/abstract=1009196>> accessed 29 June 2011

³⁶¹ *Ibid.*, 56-57

³⁶² Inderst and Ottaviani (n 351)

targeting the way investors deal with financial advice, for example forcing advisers to disclose any commission received.³⁶³ It could be suggested, therefore, that suitability is concerned mainly with the quality of the financial advice.

Stating that suitability is concerned with the quality of financial advice does not mean that it imposes a duty to inform the investor about a particular aspect of the advice, such as helping investors to make informed decisions and to warn them about the risk.³⁶⁴ Rather, it requires the adviser to make an effort to judge the impact of the proposed decision on the circumstances of investors on the basis of the information gathered from them. A conclusion as to the suitability of financial advice, therefore, will vary not only between different investors, but also for the same investor because it depends on many imperative factors including the experience of the person providing the financial advice, the circumstance of the investor and the kind and amount of information gathered from the investor.

Accordingly, it could be suggested that it is not an easy or straightforward task to determine suitability, given that there is no objective determination of it even in the case of one investor. In other words, the problem identified with this requirement is its subjectivity in relying on subjective judgment to decide its meaning.³⁶⁵ When this problem is not acknowledged, it can be mistakenly argued that the conflict underlying suitability is one between an objective suitability, on the one hand, and suitability in terms of the intermediary's subjective beliefs, on the other.³⁶⁶ The mistaken view of the existence of an objective suitability could be attributed to the SEC, when it shifted

³⁶³ Ibid, 50

³⁶⁴ This type of financial regulation is described as 'conservative paternalism', see James Fanto, 'We Are All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education' (1998) cited in Barbara Black and Jill Gross, 'Elusive Balance between Investor Protection and Wealth Creation' (2005) 26 Pace L.Rev. 27, 37

³⁶⁵ The Treasury Committee, *European Financial Services Regulation: Seventh Report of Session 2005-06* (UK Parliament, House of Commons, Stationery Office, 2006) 37

³⁶⁶ Iris Chiue, *Regulatory Convergence in EU Securities Regulation* (Wolters Kluwer 2008) 31

its initial view of suitability from ‘subjective standards’, meaning suitability in the customer’s own eyes, to ‘objective standards’, meaning in the eye of the provider.³⁶⁷ It is for this reason that it is the court’s job to rely on different expert witnesses to determine what is the common view of suitability among intermediaries rather than to identify an objective suitability.

Such characteristics of the regulatory duty may require, in the event of a private action, a reliance on experts to prove that unsuitable advice which had been supplied could not be considered suitable in accordance with the standard judgement within the industry at that particular time. Such reliance on experts was argued to be one of the main causes of difficulties associated with the law relating to securities markets. Thus, within the U.S. context, it is currently argued that an investor willing to sue for unsuitable advice, in the absence of fraud, can do no more than to bring a claim for negligence, which may be ineffective in cases where the financial advisers did advise as to the risk involved and hence no reliance on the advice is claimed.³⁶⁸ In other words, even in the event of the advice provided being considered unsuitable, this would not in itself be sufficient to establish the liability of an adviser. It is for this reason that Gedicks claims that ‘[s]tand-alone suitability actions, in which breach of the suitability obligation is the core of the action, were unusual, and customer recovery on such actions rarer still’.³⁶⁹

If suitability, as a regulatory duty, is justified on the basis of ensuring the quality and maintaining investor confidence but does not add to a private action, it would be important to know whether or not the concept of regulatory suitability is universally applicable irrespective of the context in which is applied. There are two

³⁶⁷ Hersh Shefrin and Mier Statman, ‘Ethics, Fairness, Efficiency, and Financial Markets’ (1993) 49 *Financial Analysts Journal* 21

³⁶⁸ *Ibid*, 564

³⁶⁹ *Ibid*

reasons for this enquiry to know, firstly, whether or not it could be transplanted as it is; and, secondly, if yes, whether or not the receiving legal system of suitability is entitled to alter the entitlement of suitability to suit its national context.

There is no clear answer to this question. But it seems that the underlying nature of the regulatory duty of suitability is in a continuous state of evolution in order to keep up with what is considered important in affecting the quality of advice supplied. This can be observed in the way the substantive duties of suitability has developed through litigation and regulatory initiatives which currently require financial advisers to conduct two assessments: of ‘reasonable basis’ and to be ‘customer specific’. Furthermore, a third type of assessment is currently being added to the regulatory concept of suitability. At the moment, the general application of the suitability of financial advice in financial markets in the US is imposed by the Financial Industry Regulatory Authority (FINRA).³⁷⁰ FINRA perceives the requirements of suitability to include three obligations: reasonable-basis suitability, customer-specific suitability, and ‘quantitative suitability’.³⁷¹ This additional assessment of ‘quantitative suitability’ requires a financial adviser ‘who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile’.³⁷² FINRA does not provide any definition of the term ‘excessive’ but provides some criteria to determine when conduct is considered excessive and thus in breach of ‘quantitative suitability’

³⁷⁰ This rule was introduced with the filing of SR-FINRA-2010-039, which was approved by the SEC. This rule becomes effective on October 7, 2011

³⁷¹ FINRA Rule 2111

³⁷² FINRA Rule 2111-5(c)

There are three points worth mentioning in the evolving process of suitability in the US. Firstly, the shift towards imposing suitability through the regulator rather than self-regulating organizations suggests a shift in the understanding of the optimal methods to impose suitability in financial markets. Interestingly, the movement towards imposing suitability through the regulator was attempted in the UK long before the US in the previous regulatory regime of securities markets, as illustrated in the discussion below.³⁷³

Secondly, it is not clear whether or not the evolving suitability process is reactive or proactive. A reactive process in this sense means that a regulator identifies widespread practice by practitioners and in response attempts to ensure that suitability is clearly covered in such practices. In contrast, a proactive process results from reflection on the concept of suitability itself and then attempts to develop a new modification of the concept in line with the way that financial advisory services are evolving. In principle, deciding that advice about repeated transactions or courses of action are not in the best interest of a customer is not a novel type of assessment, and in fact it is similar to ‘churning’, a well-known malpractice of stockbrokers involving moving the same money or funds from one investment to another in order to generate commission.³⁷⁴ But whether such malpractice among financial advisers becomes so common that regulators are induced to change the concept of suitability, or if financial advisory services because of de-regulation have evolved in such a way that the suitability duty needs to include quantitative assessment, are questions for future research. The former reasoning would be justified on the economic grounds that states intervene to maintain confidence and hence increases engagement, whereas the latter

³⁷³ See ch 4 for more information and detailed discussion.

³⁷⁴ The practice is also called ‘twisting’ among professionals in the US. For more examples of similar malpractices by stockbrokers such as ‘selling dividends’ and ‘breaking point sale’. More details in Michael Curley and Joseph Walker, *Barron's How To Prepare For The Stockbroker Examination* (series 7, Barrons 2005) 217-218

would be justified if the state needs to increase the certainty in market by including what a given regulatory duty imposes. The difference between these two economic explanations is important. In modern financial and regulatory theory, economic analysis and justifications are paramount not only to justify certain government interventions, but also to identify the appropriate measures to be taken, including policy options as to the subsequent means used to intervene.³⁷⁵

Finally, the shift by the SEC concerning the concept of suitability from ‘subjective standards’, meaning suitability in the customer’s own eyes, to ‘objective standards’, meaning in the eye of the provider, has resulted in different kinds of obligations being imposed. It is because of the notion of objective suitability that regulators tend to impose a duty upon advisers to collect as much information as needed to ensure that they gather a minimum level of available information before the provider can judge suitability. This suggests that, where it is possible for a regulatory duty to have several meanings, it is the view of the authority that matters.

In short, in the US experience, where suitability as a regulatory duty was first recognised, it aimed to ensure that stockbrokers would determine that the content of the advice was appropriate to the needs of customers/investors. However, the meaning of suitability is still evolving even in the jurisdiction where it was originally introduced. Currently, suitability encompasses three kinds of suitability: customer suitability, reasonable-basis suitability and quantitative suitability. It is claimed that suitability involves an exercise of judgment by the financial advisers that is likely to create difficulties for private action, as observed within the American context.

³⁷⁵ For example, the FSMA provides a set of principles that the FSA has to comply with. Among those is efficiency of economy. But the focus on the economic view can be criticised. For instance, it is argued that as a result of the common view of efficiency within financial markets ‘[t]he role of ethics in the financial community today seems to be limited to its role in financial-economic theory. Contemporary financial economists view ethics in the context of objective wealth maximization. In this context, ethics functions primarily as a constraint on behavior’ in John Dobson, ‘The Role of Ethics in Finance’ (1993) 49 *Financial Analysts Journal* 57

D) The Regulatory Requirement of Best Execution

Simply put, the regulatory concept of ‘best execution’ aims to ensure that a financial services provider who is executing a customer’s orders takes into account various factors such as price movements, timing and execution venues. To understand the need for this regulatory doctrine as well as the purpose for which it was recognised, it needs to be placed in historical context.

In his study of the duty of best execution in the late nineteenth and early twentieth centuries, Facciolo demonstrates that the doctrine was originally developed in the U.S. from common law principles, particularly agency law.³⁷⁶ Generally, common law agency principles impose fiduciary duties upon agents to secure their action in the best interest of the principal.³⁷⁷ Within securities markets these duties have evolved within American common law to require stockbrokers to execute the principal’s orders promptly, in an appropriate market, and to obtain the best price, and these are articulated as the duty of ‘best execution’.³⁷⁸

The common law development of the duty was in response to the fragmented nature of US stock markets where different markets dealt in the same security. Information asymmetries as well as the high cost of communication gave advantages to stockbrokers over many investors, which was exploited by some of the former. The availability of multi-exchanges enabled stockbrokers to buy from the lowest quoted price and sell back to investors for the highest quoted price.³⁷⁹ That was deemed to be

³⁷⁶ Francis Facciolo, ‘Broker's Duty of Best Execution in the Nineteenth and Early Twentieth Centuries’ (2005) 26 Pace L. Rev. 155

³⁷⁷ Jonathan Macey and Maureen O'Hara, ‘The Law and Economics of Best Execution’ (1997) 6 Journal of Financial Intermediation 188, 190

³⁷⁸ Ibid

³⁷⁹ For more detailed account see Jean-Pierre Casey and Karel Lannoo, *The MiFID Revolution* (CUP 2008) 59-62

in direct conflict with the agency principles that govern a broker-investor relationship, which the best execution duty aimed to remedy.

It was not until the 1960s, however, that best execution was given regulatory status. At that time, the U.S. Congress adopted an initiative called the National System for Trading Securities in order to promote national trading in securities rather than being oriented to individual states.³⁸⁰ In such an environment, experience proved that it was still possible for stockbrokers to abuse the trust of investors, a fact of which investors were well aware. It was thought that, by introducing best execution as a regulatory requirement, investors would be assured of a trading environment where competing exchanges were linked to a single national market.³⁸¹

Thus, it could be suggested that best execution as a regulatory duty was meant to bridge the gap of mistrust between brokers and investors in a multi-exchange environment. Having said that, it would be reasonable to state that best execution is unimportant, if not completely unnecessary, in single exchange environments. It follows that the importance of and the entitlement to the regulatory duty of best execution depend on the context in which the duty applies.

The micro-economic analysis of the duty itself provides rigorous justifications to sustain the regulatory doctrine of best execution in modern securities market regulation based on arguments about economic efficiency founded on two lines of economic thought. The first states that the requirement of best execution enhances the functioning of securities markets by safeguarding the accurate appraisal of a security, which helps in increasing the efficiency of the allocation of investment capital within

³⁸⁰ David Lipton, 'Best Execution: The National Market System's Missing Ingredient' (1982) 57 *Notre Dame Law*. 449

³⁸¹ Scott McCleskey, *Achieving Market Integration: Best execution, Fragmentation and the Free Flow of Capital* (Butterworth-Heinemann 2004) 51

an economy.³⁸² Thus, it could be suggested that this explanation links best execution to the role of prices in financial markets in enhancing the efficiency of the economy.

The second explanation is also based on economic efficiency, but it focuses on a different economic framework by asserting the effect of ‘best execution’ on investor confidence and subsequently on the formation of capital in enhancing the economy as a whole.³⁸³ Here it is argued that the regulatory requirement of best execution increases investor perceptions of the fairness of markets and, hence, strengthens confidence attached to the financial system.³⁸⁴ It follows then that the higher the level of confidence, the more investors and capital will come to securities markets, which ultimately lowers the costs of raising capital.³⁸⁵ This explanation is more likely to represent the underlying thoughts of the Congress in the development of best execution.

Taking these two explanations together, it could be suggested that best execution is needed to maintain the benefits sought from securities markets by, firstly, ensuring the accuracy of prices, and secondly increasing capital formation. Since best execution is important for capital formation and the efficient allocation of resources through prices, it could be argued that it is needed irrespective of the level of economic development of a country given that it has a multi-exchange environment. In other words, economic analysis suggests that best execution is as important for developed economies such as the UK as it is for developing economies like Saudi Arabia.

In short, this section demonstrates that best execution was developed at first by common law in response to the multi-exchange American securities markets in

³⁸² Macey and O'Hara (n 375) 454

³⁸³ Ibid

³⁸⁴ Ibid

³⁸⁵ Ibid

order to ensure that stockbrokers did not abuse the trust of investors. It is also illustrated that the regulatory element was conferred on the best execution concept by policymakers to maintain investor confidence in national markets. It is pointed out that the current economics literature suggests that the rationale for imposing best execution is its role in capital formation and the efficient allocation of resources through the accuracy of appraisal. Based on the two economic explanations, it is then argued that best execution is of great significance for both developed and developing countries that have multi-exchanges in their markets.

Part IV Summery and Conclusion

This chapter started by demonstrating the relatively higher importance given to securities markets in modern times. The premise of this discussion is that it is argued that the nature of private financial exchanges through legally enforceable contracts is the cornerstone of the role of securities markets in enhancing economic growth. It is shown that securities markets play a vital role in increasing the efficiency of the economy by working as a bridge between savings and wealth enhancing projects.

This chapter starts by distinguishing securities markets from other financial markets and proposes that a securities market is any organised process in an identifiable location or system through which financial contracts or claims which represent obligations or rights that have their own value and are transferable are exchanged, issued and traded. It is noted that there are different securities markets but the focus of this inquiry is mainly on capital markets, which include stock markets, bonds markets, and derivatives.

Having provided a definition of securities markets, Part I attempted to demonstrate the relatively higher importance given to securities markets in modern

times. It is shown that securities markets play a vital role in increasing the efficiency of the economy by working as a bridge between savings and wealth enhancing projects. Also, securities markets work to increase savings and distribute both credit and liquidity as well as discovering market prices for risks, events, management and liquidity. In addition, it is claimed that the spread of market oriented structures for economic activities provides additional support for the importance of securities markets in general and capital markets in particular, due to the important role they play in the process of shifting towards a market economy model as well as the transferring of the public ownership of production units to the private sector. Accordingly, it is maintained that there are public policy considerations to ensure the efficient functioning of securities markets that justify the attention given to them by policymakers.

This part also attempted to answer one of the present research questions presented as a sub-question of the thesis, which is to assess the importance of secondary securities markets, including secondary ones. It is pointed out that secondary markets play an important role in enhancing confidence in primary markets as well as increasing the supply of credit by using securities as a liquid guarantee for obtaining credit. Furthermore, it is suggested that secondary markets benefit the economy by providing prices that can be utilized to guide the process of the allocation of capital and wealth.

It is pointed out that problems of information within securities markets make it difficult to determine the quality of assets, and that these problems are of the essence of the regulation of securities markets. Accordingly, it is claimed that regulations that impose disclosure requirements aim to bridge the gap in the informational disadvantages against investors. Another rationale for regulations is to protect

investors from sharp practice and opportunistic behaviour by participants in the markets which may undermine the integrity of markets and investor confidence in them. Regulations should promote a minimum level of accepted standards that ensure the integrity of the market. A third justification is the systemic risk that certain financial institutions pose, so that regulations ensuring a minimum level of capital and liquidity are essential to minimise the possibility of such risks.

Accordingly, it is argued that securities markets, including secondary ones, are worth focusing on by policymakers in introducing regulations that aim to ensure their efficient functioning by reducing the informational disadvantages, ensuring the solvency of participants, and maintaining investor confidence against any opportunistic behaviour by participants in these markets. It follows that securities market regulations could be categorised as regulations that aim (a) to increase disclosure, (b) to ensure the solvency of participants such as liquidity requirements, and (c) to protect investors from malpractice by participants such as conduct of business regulations.

It is then argued that ensuring compliance through the enforcement of regulations is necessary, but not sufficient, for optimal and effective regulatory regime for securities markets. Private enforcement should be considered as a complement to rather than a substitute for public enforcement. The existence of the private enforcement of securities regulations helps in achieving the wider social purpose behind securities market regulations, which is to improve the process of the allocation of limited resources. Private enforcement is argued can support the achievement of this by: providing additional resources for enforcement, safeguarding the price functioning of securities markets in cases of lax enforcement, and reducing

the costs of private transaction by reducing the legal risk through more certainty and clarity in the substantive law.

Having said that, supporters of pure public enforcement of securities market regulations raise legitimate concerns as to the disadvantages of private enforcement, and particularly that private actors may neglect the wider social benefits as well as interfere with public enforcement. Such concerns are supported by considering the restrictive approach of the Supreme Court in the U.S., where the private enforcement of modern securities markets regulations for malpractice first developed for action based on Rule 10-(b).

In accommodating such conflicting concerns, the thesis argues that private enforcement within securities markets regulation, if effectively implemented, is able to provide the advantages and avoid the disadvantages. A substantial volume of literature analysing private enforcement within the U.S. context recognises its shortcomings as a result of the reliance on courts to identify and develop causes of action as well as the existence of the class-action system. The provision of private enforcement within the regulatory regime for securities markets regulations is likely to mitigate the inclination of courts to develop such actions as well as mitigating problems with class-actions suits.

Accordingly, a legitimate question is what would be an effective framework for the private enforcement of secondary markets regulations. Unfortunately, very few studies were identified in the literature which deal with the U.S. context, or provide general analysis of the private enforcement of regulations. Because of this, the thesis relies on the literature about the public enforcement of public regulation to identify what the criteria would be for an effective framework. From this, three criteria should be taken into account in designing a private enforcement framework: (a) context-

specific information about the regulatory problem; (b) the characteristics of potential private plaintiffs; and (c) the effect of private enforcement on public enforcement efforts.

In contextualising these criteria in securities market regulations, it is argued that the availability of different kinds of public enforcement policies in addition to different approaches to the execution of policies, combined with scarce research into the role of private enforcement in each approach for each policy, renders generalisation extremely difficult. Thus, building a regulatory regime that involves private enforcement taking into account a particular enforcement policy may likely hinder the flexibility needed for the regulatory authority, which makes decisions as to the choice of particular enforcement policy. It may do so by restricting the choices of available enforcement policies to the regulatory agency. Therefore, it could be argued that less attention should be given to the enforcement strategy in the institutional design of private enforcement of securities market regulation.

The preceding discussion, particularly in Part II, concludes that effective private enforcement by retail investors of securities market regulations should take into account the characteristics of potential plaintiffs. Within securities markets, three problems have been identified with private action by retail investors: the latter are not aware of their position in law, the law itself is unclear, and there is a lack of incentive for retail investors to pursue a lawsuit.

The final criterion for the effective private enforcement of securities regulations concerns context-specific information about the regulatory problem. Part III provides an investigation of the regulatory problems which suitability and best execution as regulatory duties aim to resolve.

Experience in the U.S., where suitability as a regulatory duty was first recognised, shows that it aimed to ensure that stockbrokers would determine that the content of the advice was appropriate to the needs of customers/investors. Suitability, therefore, aims to ensure that demand is properly matched to the right products in the market and subsequently the allocation of resources to this demand.

The analysis of best execution shows that, whereas the duty was developed by common law in the U.S., the regulatory element was conferred on best execution by policymakers to maintain investor confidence in national markets. It is pointed out that the current economics literature suggests that the rationale for imposing best execution is its role in capital formation and the efficient allocation of resources, through the accuracy of appraisal and investors' confidence as principals that their agents are not going to exploit them for their own profit. Based on these economic explanations, it is then argued that best execution is of great significance for both developed and developing countries that have multi-exchanges in their markets.

What distinguishes suitability and best execution from some other regulatory duties is that they are imposed on contracts between private parties and affect the contract law that the transaction is subject to. The economic analysis of the enforcement of regulations points out that, whereas public regulations without incentives which involve criminality are best suited for public enforcement, the contracting parties are in the best position to enforce contract law. In particular, this is because private parties are best able to detect a violation of the contract when it occurs, as well as being likely to overlook minor breaches of contracts in order to preserve long-term relationships. They also can determine whether or not the costs of enforcement justify pursuing action, and because of their informational advantages as

to the subject matter of the contract, they are better suited to make these choices.³⁸⁶ Accordingly, given that suitability and best execution are imposed on contractual relationships, it could be argued that private enforcement may be more advantageous than public enforcement. Consequently, it could be suggested that the private enforcement of both suitability and best execution regulations is likely to be effective in supporting the public enforcement of these particular duties.

Overall, the preceding discussion supports the existence of direct and explicit private enforcement of suitability and best execution regulations because: a) these duties interfere with the substantive obligations provided by contract law; b) private parties are better suited to detect violations of contracts; c) the incentive is reduced for courts to imply a cause of action from a statute and hence more certainty is provided; d) it could support wider social purpose of securities market regulations by reducing the uncertainty and therefore the costs of private transaction; e) it may compensate for lax enforcement by public agencies; and f) provide additional resources for enforcement in addition to those already assigned to public enforcement.

However, whereas there is no optimal paradigm to accommodate private enforcement by retail investors in a securities market regulatory regime, let alone for suitability and best execution in particular, it is crucial to point out that such a framework should take into account several factors. Firstly, difficulties face retail investors in enforcing regulations; particularly in the clarity of the substantive law, the emphasis on the existence of their rights and the lack of incentives or higher costs of litigation. Secondly, the substantive duties imposed by the regulations concerning best execution and suitability should ensure that, whatever the means by which investors' demand is directed by financial services, it should aim to facilitate the accurate end of

³⁸⁶ Klöhn (n 108); Andrei Shleifer, 'Understanding regulation' (2005) 11 *Europ. Finan. Manage* 439

ensuring retail investors' needs are promptly satisfied. Finally, in order to mitigate the disadvantages of private enforcement in terms of excessive enforcement and interference with public enforcement, a certain level of supervision and control should be exercised.

Whereas this thesis acknowledges the significance of all of these factors, there is little information available as to the practice in different countries in relation to their institutional design. Therefore, the current thesis provides a survey of the institutional design of private enforcement of these regulatory duties in both the UK and Saudi Arabia. It attempts to identify, firstly, why and how private enforcement took shape in each country and, secondly, how effective it is in facilitating the achievement of broader policy aims of compliance with securities market regulations. These investigations are followed by conclusions about the pros and cons of each national design. From this evaluation, recommendations are subsequently provided as well as a paradigm for the optimal design of private enforcement of regulations secondary securities markets.

It should be emphasised that the facts and circumstances in each country are examined in a separate chapter. By doing so the thesis endeavours to assess whether or not there are certain national restraints, whether these be legal, social or political, that may hinder the implementation of any recommendations for improvements or reforms.

Chapter Three

The United Kingdom

The chapter on the UK experience attempts to evaluate whether or not the current regulatory framework ensures that both ‘suitability’ and ‘best execution’ have been implemented in a way that permits retail investors to enforce them. The focus of discussion on retail investors is due to the limits of time and space, whereas further research would be needed to examine different classes of investors (for example professionals and financial institutions). Each class of investors involves specific circumstances needing to be examined in details. The choice of ‘retail investor’ was made in reference to the emphasis by IOSCO on this class of investors.

Accordingly, this chapter attempts to answer three questions. Firstly, what advantages do suitability and best execution, as implemented by the FSMA regulatory regime, provide to retail investors? Secondly, what are the problems with existing regulatory regime in facilitating civil actions by retail investors? And finally, what might be the way forwards in terms of improving the situation? Answers to these questions will contribute to the conclusion of this study and help answer the research question of the thesis.

This chapter is divided into four parts. Part I provides a background to the current regulatory regime in the UK. Part II examines the current regulatory framework, focusing on the techniques used for both suitability and best execution as implemented in permitting retail investor to pursue civil actions. Part III evaluates both suitability and best execution in their applied contexts, discussing the relevant definition, criteria and guidance. Finally, part IV includes a discussion and conclusions.

Part I Background

An informed analysis of the regulation of securities markets in the UK requires an understanding of the environment within which the current regulatory regime developed. There have been two major regulatory frameworks in the UK. The first was established by the Financial Services Act 1986 (henceforth FS) and the second was the regulatory framework established by the FSMA in 2000. The discussion below demonstrates problems with the FS regime particularly in regards to private enforcement, and considers whether the FSMA is different from the FS as far as enforcement by retail investors is concerned. Furthermore, it is thought important to demonstrate how suitability and best execution as implemented are of help in the achievement of the policies underpinning the FSMA. For this reason, an analysis of the suitability and best execution within the UK context is provided.

The discussion starts by considering the motivation for introducing the regulatory regime, followed by the problems associated with the FS regime and private enforcement. Thereafter, the introduction of the FSMA is detailed, including public policy underpinning it. It is followed by two subsections that review literature demonstrating the importance of suitability and best execution to the regulation of financial markets, and then links that to the public policy underpinning the FSMA. This Part concludes with the assertion of the importance of suitability and best execution to achieve public policies underpinning the FSMA.

A) The FS Regulatory Framework

It was noted in a previous chapter that, from a positive law viewpoint, modern financial services law, as a distinctive branch of state law, was first established in the U.S. in 1933.³⁸⁷ In contrast, the first distinct law as an act of the Parliament in the UK to regulate mainly securities markets was not introduced until the FS in the 1980s. There had been nonetheless some minor interventions before the FS regime and after World War II mostly requiring the registration of participants or organising them in certain ways.³⁸⁸ For example, stockbrokers were required to register with the London Stock Exchange (henceforth LSE) and to follow its rules.³⁸⁹ But regardless of various state interventions, nothing is suggested that any of these interventions resulted in the creation of a regulatory regime with a special regulator for the industry. That is because both laissez faire and pure self-regulation continued to dominate in dealing with the protection of investors in secondary markets.³⁹⁰

However, between 1982 and 1984, the Conservative government considered the status quo of securities markets to be unsustainable. The abolition of exchange controls exposed the City to great international competition.³⁹¹ Foreign firms, particularly from the US and Japan, disturbed the governance model of the self-regulation system in the UK, which was based on the assumption that there was a common community understanding ‘where shared common, culture, practice, enabled business to be conducted on the basis of trust’.³⁹² But some of the newcomers did not share these values, and by the mid 1980s an increase in the level of fraud in financial

³⁸⁷ See ch 2 Part II

³⁸⁸ For detailed discussion, see Laurence Gower, *Review of Investor Protection: A Discussion Document* (H.M.S.O. 1982)

³⁸⁹ See Edward Stringham and Peter Boettke, ‘Brokers, Bureaucrats and the Emergence of Financial Markets’ (2004) 30 *Managerial Finance* 57, 64

³⁹⁰ Sharon Chain, ‘Financial Services Regulation: Can History Teach Us Anything’ in Cartwright (n 198)

³⁹¹ House of Common, *Financial Services and Markets Bill* (House of Commons Library Research Paper 99/68, 1999) 7

³⁹² See Julia Black, *Rules and Regulators* (Clarendon Press 1997) 52. See also John Kay and others, ‘Regulatory Reform in Britain’ (1988) 3 *Economic Policy* 285

markets had become noticeable.³⁹³ In addition, public scrutiny and enforcement existing at the time was not able to ensure compliance with the rules and to maintain the integrity of the city. For instance, the Council for Securities Industry, formed by the Bank of England to co-ordinate self-regulation among participants in securities markets, had no permanent staff to deal with its broad responsibilities.³⁹⁴

Consequently, the government assigned Professor Laurence Gower to initiate a public enquiry and he published his discussion paper in 1982 followed by a full report in 1984.³⁹⁵ The underlying claim of the report was the need to change the institutional structure in order for regulation to work. The government's subsequent White Paper, *Financial Services in the United Kingdom: A New Framework for Investor Protection*³⁹⁶ implemented most of Gower's recommendations and proposed, contrary to Gower's recommendations, two tiers of regulatory agencies. The White Paper introduced a regulatory framework based on a self-regulatory regime with a statutory framework as a governance model. The institutional structure was based upon an umbrella organisation with statutory powers (the Securities and Investment Board (hereafter SIB)) overseeing self-regulating organisations (hereafter SROs).

The rationale for the two-tier structure was the combination of two assumptions. The first is the assumption that participants were better suited to organise themselves and their industry, and not to disturb the important roles of market forces.³⁹⁷ The second was that both market forces and caveat emptor are not enough on their own 'to create the necessary investor confidence'.³⁹⁸ The government

³⁹³ For example Bank Singer and Friedlander, Lloyds scandal, the failure of Johnson Matthey Bank, and the collapse of McDonald Wheeler; further details at Chain (n 388)

³⁹⁴ Note that self-regulatory associations were supervised mostly, except in insurance, by the Bank of England, see Gower (n 386)

³⁹⁵ Ibid; and also see Laurence Gower, *Review of Investor Protection: Report Part I* (H.M.S.O., 1984)

³⁹⁶ Department of Trade and Industry, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (H.M.S.O., 1985)

³⁹⁷ Ibid, 6

³⁹⁸ Ibid, 8

wanted a law that ensured disclosure and maintained competition, and a structure that cures problem with standards maintained by self-regulatory bodies. It is from these complex objectives that the two-tier structure could be understood.

Before the FS came into force in 1988, it already had been subject to criticism. For example in Part II of Gower's report, published in 1985, it was noted that due to the various services and products that financial institutions dealt with, there would be an overlap between regulatory agencies. This would require double reporting and thus increases in costs.³⁹⁹ This raised questions about the reasons for the government siding with the FS regime despite criticism about expected problems and costs. It is an area within the history of British financial law where different explanations are provided.

Different authors argue in favour of private interest theory for law that maintain the law was pushed through in response to the interest pursued by participants in financial markets. They, however, differ as to the motivation and the particular interests that were sought after by pushing the FS regime. Three prominent reasons could explain the government's decision to seek a reform in financial services with speed in the way it was.

Firstly, it is argued that the incentive to develop regulations was brought about by threat of an action by the Office of Fair Trading (hereafter OFT) against the LSE to take it to the Restrictive Trade Practice Court.⁴⁰⁰ The OFT claimed that certain practices by LSE (namely fixed commission, single capacity, and membership restrictions) impeded competition and fair-trading. The Bank of England brokered an agreement between the LSE and the government that the latter would instruct the OFT

³⁹⁹ Laurence Gower, *Review of Investor Protection: Report: Part II* (H.M.S.O., 1985)

⁴⁰⁰ The jurisdiction of the OFT was extended by the Restrictive Trade Practice Order in 1976 to include trading law in service industries. For further discussion see Michael Moran, *The Politics of Financial Services Revolution: the USA, UK, and Japan* (Macmillan 1991)

to drop the action, and in exchange the LSE would agree to reform its rules under the supervision of the Bank.⁴⁰¹ Chain argues that at this point the political autonomy of the City changed; the Bank for the first time pursued a different policy from those advocated by the City.⁴⁰² Therefore, participants sought a new structure that provides an agency that voice their concerns and protect their interest.

Secondly, the change in the nature of the City forced participants to seek a new regulatory structure that could maintain standards and confidence in financial markets. It is noted above that foreign firms, particularly from the US and Japan, were disturbing the governance model of self-regulation based on trust. With the threatened loss of confidence there was an understanding of the need to maintain and improve trust among investors, which was thought better achieved by establishing a separate regulatory agency which could produce tough regulations, effective enforcement and combat fraud.⁴⁰³ Thus, it could be suggested that this explanation proposes that the FS regime was a means for participants to re-organise themselves with no intention of the protection of investors per se.

Thirdly, the push for the FS regime came from participants fearing the impact of private law on their commercial interests. Professor Black argues that the need for government intervention arose from the ability to combine the role of a broker and a market maker at the same time, known as dual capacity.⁴⁰⁴ Dual capacity generated immediate conflicts between participants' interests as principals and agents. Black argues such conflicts of interest force those involved in financial markets, including regulators such as the Bank of England, to seek regulations to protect participants

⁴⁰¹ Also known as the Goodison-Parkinson agreement, 1983, for a historical review of the context at that time see Geoffrey Ingham, *Capitalisms Divided: The City and Industry British Social Development* (Schocken 1984)

⁴⁰²Chain (n 388)

⁴⁰³ For an detailed economic perspective of that period, see Kay and others (390)

⁴⁰⁴ The elimination of dual capacity is known as the 'Big Bang' which took place on 27 October 1986, when fixed commission and the single capacity rule were ended, Kay and others (390)

from the harsh application of private law.⁴⁰⁵ Those needs could not be resolved on the basis of self-regulating institutions whose rules lacked legitimacy and enforceability. Therefore, there was a need to establish a regulatory agency to protect participants from the consequences of private law. This need was fulfilled by the FS regime as it was.

However, all the above-mentioned explanations suffer from some serious weaknesses. Black's claim failed to address the fact that, although practitioners were seeking protection from private law, private law was still causing problems in regards to commercial conflict of interest long after the introduction of the FS.⁴⁰⁶ The first two explanations would be more persuasive if the authors had included the criticism concerning costs, or were more specific about those participants who pushed for the FS regime regardless of costs.

It is probably more suitable to examine the political and economic context surrounding the FS, which suggest that it was used as an instrument to support a policy shift in the economy. The Conservative government was about to conduct a privatisation programme of many public utilities.⁴⁰⁷ Consequently, a decrease in levels of trust among the public was not a risk that the government was willing to take. That being the case, the increased importance of financial service because of privatisation required ensuring the increase participation of investors. There was a need thus to ensure an adequate level of protection provided. Accordingly, it could be argued that the objective of the regulatory change at that time was not investor protection per se as promoted by the government in its documents, but investor

⁴⁰⁵ Black (n 390) 54

⁴⁰⁶ Law Commission, *Fiduciary Duties and Regulatory Rules: A Consultation Paper* (H.M.S.O., 1992)

⁴⁰⁷ A speech by Geoffrey Owen, 'Corporate Governance in Britain: Is Incremental Reform Enough?' (CGEP Project Paper, January 2001) <<http://www.insead.edu/v1/projects/cgep/Research/NationalSystems/CGUK.pdf>> accessed 29 June 2011

protection was seen as a means to promote the subscription in the privatisation program. This helps explaining why the FS was introduced regardless of additional costs imposed upon participants in financial markets while at the same time neglecting some legal issues arise from commercial transactions.

Moreover, this explanation helps to accommodate the development of private enforcement of regulatory rules within the FS regulatory regime. None of the three explanations of private interests could explain the introduction of s.62 and the concept of private enforcement. Section 62 of the FS act provided for a right of action for damages at the suit of a person who suffers loss as the result of a contravention of the Conduct of Business rules. It was brought into force six months after the FS regime, to permit financial institutions to have become more familiar with it.

The subsequent complaints about s.62 by participants support that the claim that FS was introduced for political reasons rather than in response to participants' pressure. Participants argued later that s.62 might encourage strategic suits to the advantage of other professionals or financial institutions.⁴⁰⁸ The speed of government response to participants' complaint about s.62 was impressive. The Parliament introduced s.62A through s.193 of the Companies Act 1989, which restricted the right of action to 'private investors'.⁴⁰⁹ Considering all that, it is possible to suggest that the government introduced the FS to increase confidence with less regards to interests of participants which was considered later on.

As far as private action is concerned, it is reasonable to assert that private enforcement was one of the regulatory tools used to enforce regulatory rules within the FS regime. It does not follow, however, it was an effective tool. The FS created a

⁴⁰⁸ See Department of Industry, *Defining the Private Investor Regulations To Be Made Under Section 62A of the Financial Services Act 1986* (Department of Trade and Industry 1990)

⁴⁰⁹ For more discussion as to the policy and development of the concept of private person under the FS regime, see *Titan Steel Steel Wheels Limited v The Royal Bank of Scotland Plc* [2010] EWHC 211 (Comm), paras 53-61

complex structure which brought into question the effectiveness of s.62 and s.62A. The institutional structure was a challenge for investors in enforcing their rights because of the complexity of rulebooks and procedures produced by many SROs. It created uncertainty not only because of the overlapping rules and jurisdictions, but also investors were confused as to where they stood before the law.⁴¹⁰

Moreover, the absence of private action as a tool for enforcing regulatory rules was combined with a lack of public enforcement. As the main regulator, the SIB lacked an effective structure and resources to meet public expectations of deterring inappropriate financial behaviour. The authority's failure of redress, enforcement and deterrence was clear; up until 1997, not one person or company had been prosecuted under the FS's mis-selling clauses.

These two factors manifested themselves in various financial scandals that attracted the attention of the public and threatened public trust. Two examples illustrate the negative impact of those scandals on the level of public trust. The first is the so-called 'Maxwell' scandal. Following the death of Robert Maxwell on 5 November 1991, it became apparent that hundreds of millions of pounds were missing from the pension funds of companies belonging to Maxwell's business empire, and that the lives of approximately 30,000 pensioners across the UK were affected. It was discovered that Robert Maxwell had essentially juggled assets around his business empire using company pension scheme assets as collateral for bank loans that were then partly used to fund a lavish lifestyle.⁴¹¹ The subsequent negative impact of the

⁴¹⁰ See detailed discussion at Iain MacNeil, 'Legislation: The Future for Financial Regulation: The Financial Services and Markets Bill' (1999) 62 *The Modern Law Review* 725, 731

⁴¹¹ For an analysis of the impact of those scandals on the level of trust see John Donaldson and Irene Fafaliou, 'Underlying Values and Consequences in Financial Services' (2003) 16 *International Journal of Value-Based Management* 265

Maxwell scandal on financial services has been recently documented.⁴¹² The authors of the paper concluded that:

‘while victims of financial crime may continue to hold a generalised trust towards the financial system, the extent of this trust may be significantly reduced. Many of the Maxwell pensioners revealed that although they continue to place some degree of trust in the financial system, the 'spread' of their 'investment portfolio' has declined’.

The second example is the so-called ‘pension mis-selling’. The 1990s saw a mis-selling of a large scale of unsuitable personal pension policies by financial advisers to two million citizens.⁴¹³ In support of the assertion that the FS was an instrument in economic shift, the government through The Social Security Act 1986 permitted, among other things, contracting out of the state pension scheme and occupational schemes.⁴¹⁴ Pensioners were able to move from one scheme to another. It emerged that some pensioners were told to opt out although they would have been better off remaining in their schemes, or opting into an occupational scheme.

It is therefore plausible to expect investors to hold negative views as a result of this complexity and the authority’s failure within the FS regime. Within this environment a new Labour government came to power with a strong vision to change the regulatory framework due to, inter alia, its complexity and lack of confidence by investors. The new regulatory framework is discussed in Part II of this chapter.

⁴¹² Basia Spalek, ‘White-Collar Crime Victims and the Issue of Trust’ (the British Criminology Conference, Leicester, July 2000) <<http://www.britisoccrim.org/v4.htm>> accessed 29 June 2011

⁴¹³ See Julia Black and Richard Nobles, ‘Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure’ (1998) 61 *The Modern Law Review* 789

⁴¹⁴ House of Common (n 389) 12-13

B) The Regulatory Requirement of The Suitability of Financial Advice

It was noted above that the term ‘suitability’ has acquired a more specific meaning within financial services and markets to refer to the “requirement that any investing strategy fall within the financial means and investment objectives of an investor or trader”.⁴¹⁵ As demonstrated that suitability as a regulatory rule was developed to imposed two duties: to ensure the product recommended is suitable on reasonable grounds and the suitability of the recommended products to the circumstances and needs of the investor. This section attempts to demonstrate the development of the regulatory duty of suitability within the UK context

An analysis of the concept of suitability in the UK demonstrates a difference between what suitability is in the US and how it has been implemented.

Initially, the requirement of suitability was introduced in the FS regime through the main regulator, the SIB, and not through SROs as in the US. The SIB Core Rule 16 states that ‘a firm must take reasonable steps to ensure that it does not ... make any personal recommendation to a private customer of an investment or an investment agreement ... unless the recommendation is suitable for him having regards to the facts disclosed by that customer and other relevant facts about the customer of which the firm is or reasonably should be aware’.

Part III of this chapter provides an analysis of the concept of suitability under the current regulatory regime established by the FSMA.⁴¹⁶ However, even though suitability was introduced under the FS regime, it is difficult to find agreement among British scholars as to what suitability entails in comparison to the US. Blair, for example, focuses her definition of suitability on the outcome, recognising it as an area

⁴¹⁵ The Options Industry Council, Glossary <<http://www.optionseducation.org/help/glossary/default.jsp?letter=S>> accessed 29 June 2011

⁴¹⁶ Part III A

somewhere along the spectrum between ‘not unsuitable’ and ‘positively and indisputably the most suitable advice’ for an investor.⁴¹⁷ Whereas McMeel and Virgo are of the view that suitability is ‘a requirement of an individualized exercise of judgment based firmly upon information obtained from the customer and other information of which the financial service provider ought to be aware’.⁴¹⁸

These two views of suitability are very different because McMeel and Virgo focus on the process upon which a suitability requirement is imposed while Blair suggests suitability is related to the outcome. Consequently, the duty of an adviser according to Blair should be wider to collect the necessary information to provide a suitable advice, while according to McMeel and Virgo the duty of adviser is narrower to exercise the judgement regarding the information provided by investors without judging whether or not the information available is sufficient to provide a suitable advice.

In contextualising these abstract differences, two important observations about the concept of suitability within the UK are identified. As to the above two views, some court decisions suggest that suitability as a requirement is more concerned with procedures rather than outcome. For instance, in *Investor Compensation Scheme v. West Bromwich Building Society*,⁴¹⁹ Evans-Lombe J emphasises that English common law view is that suitability imposes on an adviser the duty to investigate and evaluate the products and other financial arrangements available on the market.⁴²⁰ Evans-Lombe J stopped short of defining the scope of an adviser’s duty towards an investor. For example, whether there is essential information that an adviser should seek from the investor, or whether an adviser’s duty is limited to the level of

⁴¹⁷ Michael Blair, *Financial Services, the New Core Rules* (Blackstone 1991) 94

⁴¹⁸ McMeel and Virgo (n 3) 369

⁴¹⁹ [1999] Lloyd’s Rep PN 469

⁴²⁰ *Ibid*, 504

information provided by the investor. The likely explanation for that is that it would depend on the circumstances and facts of each case, but nonetheless there is nothing to indicate what the general principle is, at least in dealing with retail investors. Furthermore, there is no clear distinction in the British financial law literature between customer-related suitability and reasonable-basis suitability as in the US.⁴²¹

Accordingly, taking the two observations together, it can be suggested that the doctrine of suitability in the UK focuses only on the first component of suitability in contrast to the US. But why is this?

Several hypotheses to explain the difference are possible. Firstly, it was the implementation of the regulator in the UK that resulted in the focus on customer-related suitability. Secondly, the doctrine of suitability has evolved to fit the UK context through enforcement means other than the regulator, such as the courts. Thirdly, regardless of the regulator's attempt, reasonable basis suitability is incompatible with English private law.

The historical analysis of cases suggests that it is the first explanation that is likely to be more accurate. In rejecting the third hypothesis, it could be argued that the requirement of the suitability of financial advice was recognised under tort law before its introduction by the FS regulatory regime that involve the two duties. In *Woods v. Martins Bank Ltd* (1959)⁴²² a case before the FS regulatory regime, a bank manager offered to act as a financial adviser for a wealthy client who upon the recommendation of the manager, purchased preference shares in a company called B.R. for the total sum of £10,500. The manager negligently assured the client that B.R. was financially sound. However, B.R. later became insolvent, and the wealthy client lost his money and sued the bank. The court found that the bank had breached

⁴²¹ See for example Alastair Hudson, *Credit derivatives: Law, Regulation and Accounting Issues* (Sweet & Maxwell 1999) 88

⁴²² [1959] 1 QB 55 (Ch. Div.)

the duty of care by recommending an unsuitable investment. The conclusion as to the unsuitability of the investment was reached on the basis that the product recommended (preference shares in an unhealthy financial company) combined with the strategy (two-thirds of the investment pool) could not be considered as a safe investment.⁴²³ On the basis of the reasoning of the court, it could thus be argued that the court reached its conclusion on a view of suitability similar to those developed in the US.

Furthermore, in his comparative study, Cherednychenko argues although common law is guided by the caveat emptor principle in an advisory relationship, it was capable of developing suitability on its own if no regulatory intervention occurred.⁴²⁴ Underlying Cherednychenko's claim is the court reasoning in *Woods v. Martins Bank Ltd* which identified the two different kinds of suitability. Therefore, it could be argued that common law was capable of developing the doctrine of 'suitability' in line with developments in the American context, where the regulatory requirement was first developed. It follows that the requirement of suitability did not change because of the courts.

Given that suitability had been recognised, and could have been recognised under common law, it could be reasonably claimed that the UK practice of suitability diverged from the US as a result of the regulatory framework. It is a question thus of the benefits of divergence from the US doctrine of suitability.

In retrospect, the US experience of suitability was more related to stockbrokers and their behaviour in providing recommendation and execution at the same time. There were no such concerns in the UK. Most notably, the UK experience of financial advice was arguably affected by and viewed more from its experience

⁴²³ See also same the reasoning in *Rust v. Abbey Life Insurance Co. Ltd* [1978] Lloyd's Rep 386

⁴²⁴ Olha Cherednychenko, *Fundamental Rights, Contract law and the Protection of the Weaker Party* (European Law 2007) 518

with financial advice providers which resulted in general mis-selling of financial products (for example, pension mis-selling) rather than recommendations by stockbrokers. Thus, the different contexts in which the concept of suitability became an issue (ex. pension v. securities) may likely have led to different interpretations of suitability among regulators.

Accordingly, the UK experience as to the doctrine of suitability shows that there is a difference as the concept of suitability. On the basis of the discussion above, it could be argued that differences in concept of suitability between the US, where it was originally initiated, and the UK suggest that (1) suitability can differ from a country to another; and (2) differences between states as to the doctrine could be attributed to the regulatory framework. The next section attempts to analyse the development of the doctrine of best execution in the UK.

C) The Regulatory Requirement of Best Execution

It is pointed out above that the regulatory concept of best execution requires financial services providers executing customers' orders to take into account various factors such as price movements, timing and execution venues.

As far as the UK is concerned, the regulatory doctrine of best execution was first introduced in the FS regulatory regime as a stock-exchange rule in 1986.⁴²⁵ For a period of time, compliance with the best execution rule was not an issue as the LSE was the only stock exchange where a broker could execute a customer order for a price quoted.⁴²⁶ However, in 1997, an automated trading system for the largest companies quoted on the LSE was introduced which was commonly known as SETS (Stock Exchange Electronic Trading). Trade through SETS matched buyers and

⁴²⁵ McCleskey (n 379)

⁴²⁶ Ibid, 52

sellers automatically, which cut out the need for market makers.⁴²⁷ Trading in the traditional way was still occurring in parallel to SETS generating some divergence between prices. Accordingly, the regulatory regime was modified so that the best execution requirement could be fulfilled with the focus on the best available price. That is well-illustrated by the action taken by the Securities and Future Authority (henceforth SFA) against ICE and C. Woodgate.⁴²⁸

ICE was working as a broker and adviser for an unlisted Russian company and agreed to buy shares from the directors. The purchase price (\$3,900) by ICE was far below the actual available price for the share in the market and the customers were not aware of the difference (sold for \$18,000). The SFA fined ICE on the basis that ICE owed a duty of best execution to their customer, meaning the best price. ICE appealed against the SFA decision, but the Disciplinary Appeal Tribunal upheld SFA's action. As far as best execution was concerned, the notice issued by the tribunal clearly shows what 'best execution' entails:

'as private customers, the Directors were entitled to best execution ... [the claimants] had not given best execution in breach of SFA's rules: they had made no attempt to find out what was the best price available ... on the market ICE was obliged to obtain the best price for its customers'⁴²⁹

While the notice focused on the particular facts of the cases, it could be noted the two main duties imposed by best execution on brokers were: (1) an attempt to find out the best available price, and (2) to obtain the best price for the customer.

⁴²⁷ Dominic Connolly, *The UK Trader's Bible: The Complete Guide to Trading the UK Stock Market* (Harriman House 2005) 20

⁴²⁸ See SFA Board Notice 600, 10 October 2001

⁴²⁹ (emphasis added), *Ibid*

Accordingly, it could be argued that a broker was under a duty to make efforts to determine what was the best price available in the markets and to obtain that price.

However, the focus of best execution on the notion of best prices has been subject to criticism. It is argued that the ‘best price’ effectively restricts competition by reinforcing a tendency in securities markets to concentrate trading in a single exchange.⁴³⁰ The notion of best price would lead to a concentration of trading on SETS, and that would reinforce its monopoly position. Such argument demonstrates the difficulty facing a regulator in financial markets: the contradiction between two public interests; in this case promoting competition and protecting investors.

It is likely that there is a subtle and slow movement by the regulator in the UK to prioritise competition rather than the best interest in the client represented in the best available price. In 2000, the FSA– the authority at that time- initiated a review of best execution policy which was followed by a consultation paper in 2002.⁴³¹ The result was a shift by the FSA from the focus on the price displayed to the concept of the customer’s net price.⁴³² The new concept permitted the inclusion of other factors (such as order type, size, settlement arrangement and timing) in determining the exchange or the medium through which a customer’s order is executed.⁴³³ It was the duty of the service provider to identify the balance between these factors.

Many of the previous changes have been attributed to the influence of the EU’s efforts to regulate retail markets and increase the harmonisation among member countries.⁴³⁴ Most recently, another shift occurred as a result of the implementation of the Markets in Financial Instruments Directive (MiFID) in 2007.⁴³⁵ The MiFID

⁴³⁰ McCleskey (n 379)

⁴³¹⁴³¹ FSA, *Best Execution* (Consultation paper 154, 2002)

⁴³² *Ibid*, 4

⁴³³ *Ibid*

⁴³⁴ Moloney (n 113)

⁴³⁵ 2004/39/EC, which takes effect. November 1, 2007

promoted increased competition and reduced concentration in trading at exchanges on the basis that competition will provide better services and decrease the charges imposed by exchanges.⁴³⁶ In response, the FSA introduced its consultation paper and as a result the FSA introduced the current regulatory approach for best execution in the Conduct of Business Sourcebook (henceforth COBS), which is the subject of Part III below.⁴³⁷

However, these efforts by regulators and policymakers in promoting competition among exchanges are recognised to increase the importance of the duty of best execution. For instance, promoting competition among exchanges by regulations would create data fragmentation as to the best quoted price because of the availability of many venues that execute a security.⁴³⁸ The U.S. experience suggests the possibility of stockbrokers gaining financial advantage of the information symmetry sustained by investors in fragmented stock markets. Thus, there would a need for an instant consolidation for data by participants, whether among themselves, or provided by a third party.⁴³⁹ So long as there is no current solution to data fragmentation, the role of best execution is vital in maintaining confidence and reducing costs. Accordingly, it could be maintained that the duty of best execution is important in a regulator's efforts in developing a multi-exchanges market. Given that it is the current policy to promote competition, it could be suggested that an effective implementation of the regulatory duty of 'best execution' helps in achieving policy objectives.

⁴³⁶ For detailed impact of MiFID on the regulatory regime, a good reference is Paul Nelson, *Capital Markets law and Compliance: The Implications of MiFID* (CUP 2008) 391; Moloney (n 113)

⁴³⁷ The FSA, *Reforming Conduct of Business Regulation* (Consultation Paper CP06/19, October 2006)

⁴³⁸ The LSE, 'Understanding MiFID' (October 2005) <<http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/mifid/understanding-mifid.pdf>> accessed 29 June 2011

⁴³⁹ Ibid

To sum up, the regulatory concept of best execution was transplanted to other countries, including the UK, which did not have multi-exchange markets. In such an environment, there were no difficulties with the practical application of the rule, obtaining the best price available in the sole exchange was considered sufficient. However, once the securities environment changed, particularly stocks, by the introduction of new venues, what the rule of best execution entailed changed subsequently.

D) Concluding Remarks

The historical context of the regulatory framework is helpful in providing some specific observations about the UK experience. The first is the need to avoid complex systems. Although private enforcement was part of the framework established by the FS through s.62 and subsequently s.62A, the complexity of the FS regulatory regime resulted in difficulties for investors in determining the substantive law and then enforcing it. Whereas it is argued that clarity and certainty are important for the functioning of securities markets in previous chapters, the UK experience suggests that such lack of clarity and certainty negatively impact the regulatory regime through its effects on enforcement. Thus it could be suggested that lack of clarity in the legal system decreases the level of enforcement, including the private one, which affects the function of securities markets.

The second observation is the intervention to establish the first regulatory regime used as a means to promote certain public policies based on political ideology. It is argued that none of the private interest explanations was capable of fully explaining the outcome of the state intervention. It was then suggested that intervening in secondary capital markets to establish a regulatory regime for the first time was used as a means to achieve other policy objectives. It could be suggested

thus, that it is the public interest theory, the first theme of political economy, that could explain the intervention for the first time in financial markets.

The third observation is the influence of the domestic context on the implementation of regulatory concepts. Even though suitability was recognised under English law before it was introduced through the FS regulatory regime, it has not developed under the regulatory regime in line with concepts of suitability in the US. It is suggested that this was due to the impact of inappropriate sales techniques by financial advisory services, namely in cases of the mis-selling pensions. Such incidents shifted the focus of suitability in financial advice away from brokerage services, as in the US. In contrast, the regulatory requirement of best execution was not an issue at first when there was only one venue to execute an investor's order. But once the context changed, there was a shift in what best execution imposed on those executing customer's orders.

The fourth observation is the impact of the EU project on the regulatory regime. Whereas the EU project does not rely on a private cause of action as means of redress to customers,⁴⁴⁰ it certainly has affected the substance of the regulatory duties. For instance, notwithstanding the fact that suitability as a regulatory requirements has been identified in the regulatory regime, it could be maintained that MiFID has changed the substances of the duties to a large extent; it has required the introduction of 'appropriateness' (which permits a 'lighter touch' suitability test in certain circumstances), lowering the level of the duties imposed on advisers from recommendation from 'the most suitable' to suitable, and restrictions on the UK regime as to the suitability model chosen.⁴⁴¹

⁴⁴⁰ See the introduction of ch 2

⁴⁴¹ Moloney (n 113) 237

Finally, recognition of private enforcement does not imply its effectiveness as a tool for enforcement. The complex system established by the FS created difficulties for individuals in determining the applicable substantive law, and this negatively affected the benefits ascribed to private enforcement. Accordingly, the FS experience suggests the importance of evaluating how useful private enforcement is in context.

Part II The FSMA Regulatory Regime

Part I has examined the historical development of the FSMA, illustrating how the framework established by the FS recognised private enforcement through ss. 62 and 62A. This section examines how effective the FSMA regulatory regime is in permitting retail investors to enforce the regulatory rules of ‘suitability’ and ‘best execution’. The focus of retail investor is justified on, firstly, the assumption that the complexity of the FS regime was deemed to be solved by a simplified regulatory regime revolving around retail investors;⁴⁴² and, secondly, the emphasis placed by IOSCO on ‘retail investor’ as a class needing for protection.

Accordingly, the discussion focuses on the way the FSMA permits retail investors to enforce their rights, rather than what the regulatory rules themselves entail. It is therefore necessary to demonstrate how retail investors are defined, how the FSMA provides them with a right to enforce, and how effective the new provisions related to retail to enforce regulatory rules in contrast to the FS regulatory regime. It is thought that an appropriate evaluation of a regulatory rule requires, first, an understanding of the role of the regulator as constructed by the FSMA in providing substantive investor protection; second, how financial services are recognised; and third, how retail investors are permitted to enforce the regulatory rules of suitability and best execution. These three considerations are dealt with respectively below.

⁴⁴² Iain Ramsay, ‘Consumer Law, Regulatory Capitalism And The ‘New Learning’ In Regulation’ (2006) 28 SydLRev 9

A) The Primary Legislation: The FSMA

The current regulatory regime established by the FSMA includes all kinds of financial services within a single broad regulatory framework. Within this regulatory framework, the FSMA is the core legislation that covers all kinds of intermediation in banking, investment and insurance. Moreover, under the FSMA unified supervision is created with different regulatory powers given to a unified authority including licensing, standard setting and enforcement for both prudential, conduct of business and systemic risks.⁴⁴³ The unified regulator is thought to provide simplicity to the institutional structure of the regulatory regime and hence increase investor confidence.⁴⁴⁴

The adoption of a unified regulator has many implications, including the choice of the term ‘consumer’ rather than investor. Section 425(2)A defines consumers as any persons who ‘use, have used or may use’ or ‘have relevant rights or interests’ in a ‘regulated activity’ or with an ‘authorised person’.⁴⁴⁵ Presumably, then, the term ‘investor’ would be limited and would not facilitate the needs of generality within the FSMA regulatory regime to deal with non-investing activities, such as deposits and money transfers. Accordingly, and in line with the wording of the FSMA, the word ‘consumer(s)’ is used in the following text to refer to the protection provided by the FSMA regime to investors in secondary capital markets. However, where the term “investor” is used, it refers to the theoretical and intellectual meaning in economic and legal literature rather than the perception intended within the regulatory framework.

⁴⁴³ See Goodhart (n 217). The Labour Party’s financial policies are available in the Labour Party handbook before the election ‘New Labour, New Life For Britain’ (1996), see a review at <http://www.ennenjanyt.net/2-03/lahti.htm> accessed 29 June 2011

⁴⁴⁴ For a detailed discussion as to the government view and the approach taken, see Marina Milner and Keith Syrett, ‘Personal Pensions and the Financial Services Authority: New Chapter or Same Old Story’ (2000) 51 N. Ir. Legal Q. 141

⁴⁴⁵ Section 425 (2) A and (3)

Consumers' protection is an objective of the FSMA regulatory regime. Section 2(2) of the FSMA maintains that the regulatory objectives of the authority are: (1) maintaining confidence in the financial system, (2) ensuring the stability of the financial system, (3) consumer protection, and (4) the reduction of financial crime.⁴⁴⁶

Of particular concern is s.5 of FSMA, which spells out the details of the regulatory objective of the 'protection of consumers', which is defined as 'securing the appropriate degree of protection for consumers'.⁴⁴⁷ The FSMA states that, in determining the appropriate level of consumer protection, the authority –the FSA– should take into account: (1) the kind of risk involved in the investment or transaction; (2) the difference of experience enjoyed by consumers 'in relation to different kinds of regulated activity', which includes the information provided by the FSA in its exercise of the consumer education function; (3) the need of consumers to have advice or accurate information; and (4) 'the general principle that consumers should take responsibility for their decisions'.⁴⁴⁸ The FSMA allows the FSA to determine the priority of any of these factors, stating that there is no 'obligation on the Authority to place particular weight on any one of these factors'.⁴⁴⁹ It could be suggested, therefore, that the FSMA permits the FSA to differentiate between investors on the basis of the risk involved, how experienced the consumers are, the amount of information provided by the FSA in its education function, the need for advice, and the responsibilities of consumers.

It is likely that because of the extensive powers given to the FSA, the FSMA provides guidance to the FSA in making its decisions. These are known as the 'regulatory principles'. They require the FSA to take into account in discharging its

⁴⁴⁶ Section 2 of the FSMA as amended by Financial Services Act 2010.

⁴⁴⁷ Section 5(1)FSMA

⁴⁴⁸ Section 5(2) FSMA

⁴⁴⁹ FSMA c. 8 Explanatory Note, para 2, at paragraph 39

regulatory functions: (1) the efficient and economic use of resources; (2) the responsibilities of managers (or authorised persons); (3) the burdens proportionate to benefits; (4) the facilitation of innovation; (5) maintaining the international competitiveness of the UK as a financial centre; (6) minimising the adverse effects of competition arising from the authority's discharge of its function, (7) facilitating competition between regulated persons; and (8) 'enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system)'.⁴⁵⁰

The change in the institutional structure and the extensive powers of the FSA in protecting consumers have induced some to suggest a change in the philosophy of financial services regulation in the UK. It is noted above that the government's main focus with regards to the FS regulatory regime was to maintain the principle of caveat emptor with a focus on disclosure. Schooner and Taylor maintain that that FSMA represented a shift in the philosophical justification of financial markets from an economic justification "freedom-with-disclosure" towards moral grounds (to take into account consumers' need for advice and accurate information).⁴⁵¹ The FSMA was meant to provide fairness for retail investors in the financial services industry in contrast to the philosophy of caveat emptor with disclosure.⁴⁵² Such a suggestion could be supported by the requirement of 'fairness' in awards made by the Financial Ombudsmen Services (henceforth FOS).⁴⁵³

⁴⁵⁰ FSMA s.2(3), as amended by the Financial Services Act 2010 s.2(2)(b)

⁴⁵¹ Heidi Schooner and Michael Taylor, 'United Kingdom and United States Responses to The Regulatory Challenges of Modern Financial Markets' (2003) 38 *Tex.Int'l L.J.* 317, 334

⁴⁵² For detailed discussion on the fairness of the FSMA, see Department of Trade and Industry (n 406)

⁴⁵³ For a brief explanation about the FOS see text to n 558. Within the legal context the terminology 'ombudsman' currently means a person or an organisation that 'deals with complaints from the public regarding decisions, actions or omissions of public administration' More details are available from International Ombudsman Organisation, <<http://www.law.ualberta.ca/centres/oi/About-the-I.O.I./Concept-and-Organization.php>> accessed 29 June 2011

Thus, it could be reasonable to state that the FSMA recognises the protection of investors as an objective of the regulator and the regulatory regime. The FSMA differentiates between investors in regards to protection according to the risk and the product, experience, amount of information, the need for financial advice and the responsibility of consumers. By permitting the authority to differentiate between investors in their needs for financial advice and experience, the FSMA is, relatively speaking, fairer with respect to investor protection in comparison to the FS. The next sections examine how the two regulatory requirements of suitability and best execution can help in achieving those regulatory objectives.

B) The Scope of the FSMA

The techniques used by the FSMA in determining the scope of the act are the financial activities and persons involved. Upon these two factors, the protection of the FSMA can essentially be determined.

The principal technique deployed by the FSMA to ensure adherence to the regulatory framework and to the authority is the so-called “General Prohibition”. Section 19 states that no person should carry on investment business in the UK unless he was authorised so to do by the authority.⁴⁵⁴ The FSMA considers any breach of the general prohibition to have far-reaching consequences; thus, in addition to establishing a right to sue for a breach for consumers, a person who is in breach of the general prohibition is subject to criminal prosecution.⁴⁵⁵

The FSMA provides two categories of regulated activities included in the general prohibition: firstly, the activity of a specified kind and related to specified investment; and, secondly, where specified activity is related to property of any

⁴⁵⁴ Section 19 of the FSMA

⁴⁵⁵ FSMA s.23

kind.⁴⁵⁶ The term ‘investment’ used in the FSMA for the purpose of breaching the General Prohibition includes ‘any asset, right, or interest’ in the context of regulated activities,⁴⁵⁷ and financial promotion.⁴⁵⁸ The FSMA confers to the Treasury the task of spelling out the meaning of investment of specific kinds and requires it to publish orders as to the meaning of ‘investment’. Accordingly, reference to secondary legislation is needed to determine what ‘investment’ includes.

The phrase ‘investment of a specific kind’ is clarified by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (henceforth the Order).⁴⁵⁹ The Order lists different types of investments for the purpose of the FSMA,⁴⁶⁰ including shares (Article 76), options (Article 83), futures (article 84) and bonds (articles 77 and 78).

The Order clearly brings both financial advice and execution as services to the scope of the FSMA by providing details as to the ‘regulated activities’. These activities that are related to the broker, which need to take permissions when According to the Order, the following services are considered ‘investment activities’ for the purpose of the FSMA: agreeing to carry on a regulated activity (article 64); arranging (bringing about) deals in investments (article 25(1)); sending dematerialised instructions (article 45(1)); dealing in investments as agent (article 21); dealing in investments as principal (article 14); making arrangements with a view to transactions in investments (article 25(2)); managing investments (article 37); and operating a Multilateral Trading Facility (MTF) (article 25 D). Financial advice is included within the definition of ‘investment activities’ by article 53 of the Order covering: advising on investments for an investor or a potential investor (article 53).

⁴⁵⁶ FSMA ss.22 (1) a and 22(2) b

⁴⁵⁷ FSMA2000 s.22 (4)

⁴⁵⁸ FSMA2000 s.21 (14)

⁴⁵⁹ SI 2001/544 made under FSMA200 s.22 Sch.2

⁴⁶⁰ FSMA s.22

The previous paragraphs demonstrate that both financial advice and executing customers orders by brokers are within the scope of the FSMA. Execution orders for consumers is recognised as a service related to ‘investment of specified kinds’, that includes securities. Advice subject to the general prohibition includes that on securities, which concerns buying, selling, subscribing to, or underwriting a security or exercising any right conferred by such security to buy, sell, subscribe to, or underwrite a security.⁴⁶¹ Accordingly, both financial advice and executing customers’ orders are considered within the scope of the FSMA.

Given that both services are within the scope of the FSMA, they are within the parameter of the ‘General Prohibition’. The FSMA clearly establishes a consumer’s right to a cause of action for a breach of the general prohibition. Section 26(1) declares that an agreement reached with a provider in breach of the General Prohibition is firstly, unenforceable, and, secondly, that the victim of a breach of the General Prohibition is entitled to recover the money or the property paid or transferred under the agreement, as well as compensation for any loss ‘sustained as a result of having parted with it’.⁴⁶² This wording is presumed to be wide enough not only to include loss of interest on the value of the money paid, but also to include losses that were not foreseeable by either party at the time of transaction.⁴⁶³

The FSMA provides similar protection for a consumer who reaches an agreement with an authorised person, but as a result of an inducement by unauthorised persons. This could arise simply because of ‘a contract ... entered into as a result of investment advice given by an unauthorised third party’.⁴⁶⁴ Section 27

⁴⁶¹ See Art. 53 of the Order

⁴⁶² FSMA s. 26 (2) (a) and (b)

⁴⁶³ McMeel and Virgo (n 3) 414

⁴⁶⁴ FSMA Explanatory Note, para 3

declares that such an agreement is unenforceable and a consumer is entitled, inter alia, to compensation.⁴⁶⁵

The approach of the FSA with respect to a breach of the General Prohibition has three main characteristics that facilitate its usefulness to ‘private enforcement’. Firstly, the FSMA does not restrict the right to classes of consumers; accordingly, there is no need for an examination of the entitlement of a consumer to a cause of action. Secondly, the FSMA provides neither exception nor reference to general principles of private law particularly for damages; thus, there is no application for causations or reliance in accordance with the general principles of private law, which may restrict a cause of action. Thirdly, the amount of damages provided for those dealing with a person in breach of the general prohibition is generous to include losses or profits which were not expected at the time of contracting.

These three characteristics illustrate that private enforcement with respect to the General Prohibition is unique in comparison to other cause of actions provided by the FSMA. For example, in case an authorised service provider supplies a service out of the scope of its permission, the FSMA permits, in some cases, consumers to sue according to the tort of breach of statutory duty.⁴⁶⁶ By accommodating private enforcement of the rule through a tort action, the consumer’s right to sue is undermined because private law may not only make it difficult to enforce, but reduce the amount of compensation, such as contributory negligence.⁴⁶⁷

⁴⁶⁵ FSMA s.27

⁴⁶⁶ FSMA s.20. The FSMA does not details what the prescribed cases are and are left to secondary legislation, namely Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001/2256 (henceforth ROA), reg. 3 and reg.4

⁴⁶⁷ For further discussion about tort for a breach of statutory duty, see text to n 552.

The claim of the negative impact of the private law principles is well illustrated by the case *Re Whiteley Insurance Consultants (WIC)*.⁴⁶⁸ WIC was an insurance intermediary which had issued policies that it had no authority from the insurers to issue, or where the insurers did not even exist. From January 2005, insurance intermediaries were required to obtain authorisation from the FSA. WIC went bankrupt a short time after obtaining authorisation as an insurance intermediary, and an action was brought to determine what amounts policyholders were permitted to prove in WIC's liquidation. The court decided that WIC effectively acted as the insurer – receiving premiums and paying claims - and, hence, was carrying out the insurance policies as principal and was liable to policyholders. Consequently, holders of WIC's policies issued before January 2005 enjoyed the right to the unenforceability of their contracts, since WIC was not authorised at that time and, therefore, they were entitled to a return of their premium and compensation for any loss sustained as a result of having previously parted with their premiums. In contrast, holders of policies issued after the authorisation as an insurance intermediary of WIC in January 2005 had a tort for a breach of statutory duty according to s.20 and thus their contracts were enforceable. As a result, policyholders received nothing since they did not suffer losses as they enjoyed insurance coverage from WIC during that time.

There is a case to be made as to the WIC judgement. It could be argued that the difference is in the remedy available rather than private law principles that resulted in the outcome of WIC case. While it is a correct and just objection, it misses the principal point. The principal argument in this section is that 'private enforcement' of the General Prohibition is treated differently from other rules,

⁴⁶⁸ Also known as *Kingfisher Travel Insurance Services (a firm)*) [2008] All ER, [2008] EWHC 1782 (Ch)

including the availability of enforcement. WIC demonstrates the benefit if the availability of unenforceability.⁴⁶⁹ It could be suggested thus that it is possible to have a cause of action that is not subject to traditional law principles.

To sum up, the FSMA provides for private enforcement for consumers dealing with unauthorised persons. Four elements add to the effectiveness of private enforcement of the General Prohibition: the substantive law: clarity concerning the breach, availability to all consumers, avoidance of the application of general law principles, and generous compensation since there is no reduction to the damages. It is noted also that the FSMA provides two remedies, compensations and unenforceability, which consumers need to choose between.

C) The Authority: The FSA

The way that the two regulatory duties of suitability and best execution have been implemented in the UK dictates how to address the issue. Both requirements are imposed through the COBS published by the FSA. A non-compliance with a rule in COBS can give rise for private enforcement. Of particular importance is s.150 of the FSMA, which supplies a cause of action for a breach of statutory duty to a private person in cases of non-compliance with the rules introduced by the authority. Consequently, an analysis is required of the FSA role in financial services as a publisher of the COBS.

It is noted that the FSMA established a unified regulator for all financial markets, and delegates powers to the FSA to supervise, manage and publish rules to regulate both financial services and the behaviour of authorised individuals and firms.⁴⁷⁰ The powers given to the FSA vary, including prudential and accepted conduct, authorisation, enforcement, listing, and financial promotions. In order to

⁴⁶⁹ Subject to court discretion, FSMA2000, s.28 (2)

⁴⁷⁰ See Part X of the FSMA

ensure a degree of accountability and to restrict the wide powers given to the FSA, a separate Financial Services and Markets Tribunal (henceforth the Tribunal) was established which is responsible for discharging several of the functions conferred by FSMA.⁴⁷¹ The Tribunal may receive appeals against decisions by the FSA in discharging its supervisory, regulatory and enforceability functions, and may also give a party permission to appeal to the Court of Appeal on a point of law arising from its decisions.⁴⁷² Thus, it could be argued that the FSA enjoys rule-making powers which are subject to the Tribunal.

Moreover, it could be maintained that the rule-making powers given dictate that the FSA should be exercised to inter alia protect investors. Such statement could be inferred from the clear regulatory objectives that FSMA defines the FSA in s.2(2): (1) maintaining confidence in the financial system, (2) the financial stability of the financial system, (3) consumer protection, and (4) the reduction of financial crime.⁴⁷³ It is illustrated above that s.5 spells out the details of the regulatory objective ‘securing the appropriate degree of protection for consumers’.⁴⁷⁴

In maintaining consumer protection, it is noted that the FSMA requires the FSA to take into consideration the risk involved, the relative experience of consumers, the need of consumers to obtain financial advice or accurate information, and the consumer’s responsibilities for their decisions.⁴⁷⁵ Furthermore, the FSMA delegates to the FSA the task of determining the priority among these factors.⁴⁷⁶ Accordingly, in its role in maintaining public confidence, it could be suggested that

⁴⁷¹ FSMA ss.132 (1) and (2)

⁴⁷² FSMA ss. 132 (3) and 133

⁴⁷³ FSMA s.2 as amended by Financial Services Act 2010

⁴⁷⁴ FSMA s. 5(1)

⁴⁷⁵ FSMA s.5(2)

⁴⁷⁶ FSMA c. 8 Explanatory Note, para 2, at paragraph 39

the FSA has a wide power as to how to define the relative level of protection provided for retail clients.

Moreover, the FSMA obliges the authority to exercise its rule-making powers in writing, but provides flexibility by allowing the FSA to publish all rule-making instruments in such a way that appears to the FSA to be best calculated to bring it to the attention of the public.⁴⁷⁷ To simplify and provide better communication with stakeholders, the FSA published a handbook (the Handbook) which details all of its powers and is divided into several parts.

In protecting the interest of consumers, the FSMA delegates to the FSA the power to define the accepted behaviour by authorised firms in financial services.⁴⁷⁸ Of particular importance to the conduct of services providers are two groups of regulatory rules: the Principles for Business (the Principles) and COBS.

The Principles are general statements with respect to the rules of conduct applicable to all authorised persons carrying out regulated activities in the UK.⁴⁷⁹ Their main focus is an authorised person's responsibilities when undertaking regulated activities.⁴⁸⁰ Eleven principles describes the recommended conduct of business affairs: 1. integrity, 2. skill, care and diligence, 3. management and control, 4. financial prudence, 5. market conduct, 6. customers' interests, 7. communications with clients, 8. conflicts of interest, 9. relationships of trust with customers, 10. clients' assets, and 11. relations with regulators.

⁴⁷⁷ FSMA s.153

⁴⁷⁸ FSMA s.138(1)

⁴⁷⁹ For the FSA's power to publish rules see FSMA ss. 138,145,150(2), and 156, and to publish guidance FSMA s.157

⁴⁸⁰ Not to be confused with the Statements of Principles for Approved Persons (SPAP). SPAP are made in accordance with s.64 of FSMA and focuses on authorized individuals' responsibilities when undertaking controlled functions.

However, even though the Principles are the main justification for different disciplinary sanctions imposed on authorised persons,⁴⁸¹ the FSA clearly states that they do not give rise to the right of a civil action against authorised persons as provided by FSMA s.150.⁴⁸² Additionally, English courts have refused to recognise a cause of action for investors for a breach of a Principle,⁴⁸³ although FOS's decision can be based on the Principles alone.⁴⁸⁴ Consequently, it could be reasonably maintained that the Principles introduced by the FSA do not supply any added value for private enforcement.

In contrast to the Principles, some of the rules in COBS permit private enforcement in case of breaches of these rules. The FSA states that some rules will not give rise to actionability. To clarify this, the FSA introduces three kinds of provisions in the COBS: rules, evidential, and guidance.⁴⁸⁵ Rules actionable by a private person are marked with the letter R in COBS.⁴⁸⁶ 'Evidential provisions' indicate the expected conduct to be followed by service providers in complying with a specific rule; however, according to the FSA, 'evidential provisions' are not actionable and marked with a letter E in COBS. FSA's guidance in the Handbook lacks both the binding nature of the general rules and the indicative status of evidential provisions and also non-actionable, and are with a G letter in COBS.⁴⁸⁷

The COBS provides different levels of protection to different classes of investors by different kinds of rules that could be privately enforceable. For this

⁴⁸¹ FSA, *Enforcement Annual Performance Account 2007/2008* (The FSA), 2008) para 10 <http://www.fsa.gov.uk/pubs/annual/ar07_08/Enforcement_report.pdf> accessed 29 June 2011

⁴⁸² The FSA Handbook PRIN 3.4.4. R

⁴⁸³ In *Clairon Ltd v. National Provident Institution*, [2000] 1 WLR 1888, the case was ruled in accordance with the previous regulatory regime and SIB's Principles.

⁴⁸⁴ *R (on the application of the British Bankers Association) v Financial Services Authority and another* [2011] EWHC 999

⁴⁸⁵ FSMA s.149(1)

⁴⁸⁶ The power of discretion of the actionability of the rules is confined to the FSA according to FSMA2000 s.150(4), but it excludes listing rules and rules on the appropriate level of financial resources.

⁴⁸⁷ FSA powers to give guidance in accordance with FSMA s.157

reason, it imposes on authorised firms the duty to determine the category that a consumer belongs to. This duty is introduced as the duty of ‘classifying a client’.⁴⁸⁸

Given the benefits of the duty of ‘classifying a client’, it is reasonable to expect clarity as to the criteria which differentiate between these classes. Inexplicably, while the COBS provides the highest level of protection to retail client, there are no criteria or definition to determine this class of investor. According to the Glossary in the Handbook, a retail client is a consumer who is not a professional, nor a counterparty client. Consequently, this passive approach of the Handbook requires determining the other two categories. The category of ‘professional client’ is divided into two sub-categories.⁴⁸⁹ firstly, per se professional clients, which includes any person whose regular occupation or business is the provision of one or more investment services and/or activities on a professional basis, such as investment firms, institutional investors, central banks, and insurance companies.⁴⁹⁰ The second sub-category is the ‘elective professional client’ which includes clients who choose to be re-categorised from being a retail client in order to access certain financial products.⁴⁹¹ Similarly, the category of ‘eligible counterparty’ is divided into two sub-categories.⁴⁹² There is a list of institutions deemed to be ‘per se eligible counterparty’, such as pension funds, central banks and governments.⁴⁹³ The other sub-category is ‘elective eligible counter party’, who is a per se professional client with a share capital of at least £10m, and who asks to be treated or categorised as a eligible counterparty.⁴⁹⁴

⁴⁸⁸ COBS 3.1.4R

⁴⁸⁹ COBS 3.5.1R

⁴⁹⁰ COBS 3.5.2R

⁴⁹¹ COBS 3.5.3R, for example, individuals with high experience and understanding, special purpose vehicles, or overseas financial institutions.

⁴⁹² COBS 3.6.1R

⁴⁹³ COBS 3.6.2R

⁴⁹⁴ COBS 3.6.4R

The COBS permits the movement of clients between these categories with restrictions. In cases where a client is to be re-classified to a lower level of regulatory protection, the COBS requires firms to follow procedures to ensure that a client understands the low level of protection and the high risk involved, including, *inter alia*, conducting a qualitative assessment of client knowledge and expertise before re-categorising the client.⁴⁹⁵ The COBS indicates that it is the responsibilities of consumers to request a re-categorisation if they cannot assess or manage the risk.⁴⁹⁶ The COBS, however, permits authorised persons to improve the level of protection provided for consumers on the initiative of the authorised person, such as in treating a *per se* eligible counterparty as a professional client, or treating *per se* professional client as a retail client.⁴⁹⁷ The COBS marks most of categorising clients rules with a letter R, which means that in case of non-compliance consumers have the right to sue for inappropriate categorisations.

In writing the rules in COBS, the FSA adopts two terms (consumer and client) to define the scope of rules, which may create confusion. According to the Glossary, the word ‘customer’ encompasses retail and professional clients, but excludes the eligible counterparties.⁴⁹⁸ In contrast, the word ‘client’ encompasses all three categories.⁴⁹⁹ This distinction is important and will be used throughout the following discussion.

In practice, the duty of classifying clients has two consequence of significant importance to the inquiry of the present study. Firstly, the process of classification helps in identifying those consumers entitled for actionability. Many rules in the

⁴⁹⁵ COBS 3.5.3R (1) Both elective eligible counterparty and elective professional client must be requested by the client herself, COBS 3.5.3 R, COBS 3.6.4 R, in each case, the firm is under an obligation to notify the client about the risk of losing the protection provided by the regulation

⁴⁹⁶ COBS 3.7.2 G

⁴⁹⁷ COBS 3.7.3R

⁴⁹⁸ The Glossary

⁴⁹⁹ *Ibid*

COBS are actionable for retail clients (the other two categories of client being the ‘professional’ and the ‘eligible market counterparty’). Secondly, the classification of clients helps to focus regulatory protection upon those clients who need it most. Certain obligations are considered by the FSA to be provided to the retail client only,⁵⁰⁰ or to retail clients and professionals but excluding market counterparty consumers.⁵⁰¹

To sum up this section, the FSA is the main authority in financial services in the UK and enjoys the power to set the rules as well as the discretion to decide which rules are actionable. In exercising its powers, the FSA introduced the Principles, which does not rely on private enforcement, whereas COBS includes rules that can provide for private enforcement. The FSA ascribe certain levels of protection, including private enforcement, to classes of consumers and requires authorised firms to categorise their clients. Within this framework, the importance of the COBS stems from the fact that its rules govern and provide for both suitability and best execution. According to s.150 of the FSMA, some COBS’s rules can constitute grounds for cause of action for a breach of statutory duty in the case of a breach by an authorised person. Accordingly, s. 150 and its effectiveness in providing private enforcement for regulatory rules are examined in details in the next section.

D) Private Enforcement of COBS

It is noted that there is a cause for private enforcement in case of a breach of the General Prohibition, that is the duty of financial service providers to obtain permission for regulated activities. This section deals with private enforcement for a

⁵⁰⁰ Such as polarization and status disclosure rules, which apply only to advice given to private customers.

⁵⁰¹ As in provision related to the obligation on a firm to take reasonable steps to communicate in a way which is clear, fair and not misleading, see COBS 21.1.1 R, save in the case of an authorised unit trust scheme COBS 2.1.2

breach of the duty imposed on authorised firms to follow the rules introduced by the FSA. It should be emphasised that the FSMA provides private enforcements for breaches of several duties imposed by the FSMA, such as the duty not to employ a prohibited person.⁵⁰² Given limitations of space, it is thought appropriate here to centre the discussion on the private enforcement of COBS since both suitability and best execution are imposed by its rules.

The consumer right to sue in case of a breach of a rule supplied by the authority is provided by s.150, which confers a right to “private persons” to sue a regulated person for a breach of statutory duty in the case of contravention of a rule imposed by the FSA. The SMA states that a person in breach of s.150 is not guilty of a criminal offence,⁵⁰³ and neither does a contravention of s.150 render an agreement void or unenforceable.⁵⁰⁴ Also, the FSMA limits available remedies to being to sue for damages only, and also excludes listing and prudential rules from the application of s.150.⁵⁰⁵

Accordingly, it could be suggested that under s.150 there are three conditions to bring an action. Firstly, there has been a contravention of a rule introduced by the FSA falling within s.150.⁵⁰⁶ Secondly, the contravention has caused a loss for the private investor, and thirdly, the individual suffering the loss is considered a private person.⁵⁰⁷

However, s.150 states that

⁵⁰² FSMA, Part V, s.56 (2). However, the investor’s right to sue is provided by a different provision, namely s.71.

⁵⁰³ FSMA s.51 (1)

⁵⁰⁴ FSMA s.151 (2)

⁵⁰⁵ FSMA s.150 (4)

⁵⁰⁶ FSMA s.150 (1)

⁵⁰⁷ As provided by ROA reg. 3,(c) ,and reg. 6(2) (3)(c)

‘[a] contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty’.⁵⁰⁸

By accommodating the cause of action into a tort action for a breach of statutory duty, there are further requirements that a ‘private person’ needs to fulfil. For this reason, it is deemed necessary to provide, firstly, the requirements for tort for a breach of statutory duty, and secondly, an examination of the effectiveness of this tort to enhance private enforcement.

A claim for a breach of statutory duty is an action distinct from other tort actions under English law.⁵⁰⁹ Moreover, among major common law jurisdictions, Harpwood maintains that only English law recognises the tort for a breach of statutory duty as distinct from other torts.⁵¹⁰ Probably, what makes tort of breach of statutory duty less appealing for other common law countries is that the damages and remedies provided are the same as for tort generally.⁵¹¹ But despite its damage measures being indistinguishable from other tort actions, Mcmeel and Vigro point out that the advantages of the tortious statutory claim is, firstly, to circumvent the need to argue that a duty of care should be recognised under tort law, and, secondly, to supply a more detailed picture of the appropriate standard of care for a particular activity.⁵¹² Taken together, these different views suggest that the expected benefit of s.150 is to facilitate the recognition of a regulatory duty under tort law, to provide an additional more thorough picture of the standards of care for a duty, or possibly both.

⁵⁰⁸ FSMA s.150(1)

⁵⁰⁹ *Thornton v Kirklees Metropolitan Borough Council* [1979] QB 626, 642.

⁵¹⁰ Vivienne Harpwood, *Modern Tort Law* (7th ed., Routledge-Cavendish 2009) 187

⁵¹¹ *Building and Civil Engineering Holidays Scheme Management Ltd v Post Office* [1966] 1 QB 247

⁵¹² McMeel and Virgo (n 3) para 7.07

Commentators on English law identify five requirements for a successful claim for a tort for a breach of statutory duty.⁵¹³ Firstly, a claimant's interest that has been injured must be within the scope of protection afforded by the legislation, or it was the intention of the statute to protect it.⁵¹⁴ Secondly, there is no presumption that a breach of statutory duty which results in harm to an individual is actionable in itself.⁵¹⁵ Unless otherwise clearly specified, a court has to examine whether or not a duty is actionable. Thirdly, there has been a breach by the defendant of requirement of the duty towards the claimant. Fourthly, there has to be a loss; in a financial context, losses can be more than a diminution of value of the funds placed for investment that fall at once below their value.⁵¹⁶ Losses will also include 'the loss of unrealised gain'; any additional loss because of the lack of gain or increase in value which would have come about but for the breach in question.⁵¹⁷ Finally, a claimant must establish that the losses suffered were caused by the breach of the duty. Lord Hoffmann's speech in *South Australia Asset Management Corporation v. York Management Ltd*⁵¹⁸ clearly states the position of English law:

'A [claimant] who sues for a breach of duty imposed by the law (whether in contract or in tort or under statutes) must do more than prove that the Defendant has failed to comply. He must show that the duty was owed to him and that it was a duty in respect of the kind of loss which he had suffered

⁵¹³ John Murphy and Harry Street, *Street on Torts* (12th ed, OUP 2007) 491-511; Harpwood (508) 188-199; McMeel and Virgo (n 3) paras 15.01-16.03

⁵¹⁴ This requirement is reaffirmed with respect of the FSMA in *Hall v Cable and Wireless Plc* [2009] EWHC 1793 (Comm)

⁵¹⁵ *Lonrho Ltd v Shell Petroleum Co Ltd (No 2)* (No.2) [1982] AC 173; *Hall v Cable*, *ibid*

⁵¹⁶ It includes higher fund management charges, poor interest returns, set-up costs, and exit penalty.

⁵¹⁷ *Nestle v. National Westminster Bank plc* [1994] 1 All ER 118, at 140 per Legatt LJ; *Esso Petroleum Co Ltd v. Mardon* [1976] 2 All ER 801; *South Australia Assets Management Corp'n v. York Management Ltd* [1996] 3 All ER 365

⁵¹⁸ [1997] AC 191

... normally the law limits liability to those consequences which are attributable to that which made the act wrongful'.⁵¹⁹

Consequently, from a regulatory point of view, it could be argued that s.150 is an important tool that permits retail investors who are classified as private investors to acquire a legitimate claim against a services provider. By doing so, the FSMA provides the actionability of the rule and defines the scope protected to be limited to 'private investors' as required by an action of tort for a breach of statutory duty.⁵²⁰

However, such a view has been widely criticised by commentators who have examined s.62A of the FS regime.⁵²¹ The ineffectiveness of s.62A resulted mainly from its restrictions of the right to sue to private persons, which 'ensured that it is only those who probably cannot afford to take action, who have the right to do so. A private investor would be unlikely to make a loss of the kind of magnitude that would render the cost of legal action feasible'.⁵²² In other words, the 'incentives for such an individual to enforce regulatory compliance are ... likely to be at their very weakest for this particular group of individual' which consequently 'severely curtails that potential both on the formal level and on the functional level [of s.62A]'.⁵²³

Accordingly, it could justly be suggested that s.62 was ineffective because of the restrictions of its scope to those unable to rely on it. Such argument supports the claim in chapter two that in financial markets it is common that investors lack an incentive to enforce their rights and therefore render traditional private enforcement mechanisms ineffective in reaching the expected benefits of financial markets.

⁵¹⁹ Ibid, at 211-213

⁵²⁰ FSMA s.150(1)

⁵²¹ See for example Iain MacNeil, 'FSA 1986: Does s.62 Provide an Effective Remedy for Breaches of Conduct of Business Rules?' (1994) 15 Comp.Lawy 172; Julian Pritchard, 'Investor Protection Sacrificed: the New Settlement and s.62: Part 2' (1992) 13 Comp. Lawy. 210

⁵²² Pritchard, *ibid*, 212

⁵²³ Gray (n 96) 415

In similar vein to s.62A, s.150 restricts an action to a ‘private person’. Private persons are defined by the secondary legislation to include all individuals and business not involved with financial services with any kind of business.⁵²⁴ This restriction was carried over from the previous regulatory regime and justified with the same reasoning; to exclude financial firms and corporations from enjoying the right to sue for technical breaches of rules.⁵²⁵ Therefore, it is possible to expect s.150 to be attacked using the same reasoning as in critique above of s.62A. This does happen to be the case. For example, MacNeil, who thoroughly evaluated s.62A, describes the private enforcement provisions in the FSMA, and particularly s.150, as ‘a dead letter’ for reasons similar to those given about s.62A.⁵²⁶

Additionally, a recent court decision may further restrict the scope of s.150 and subsequently its effectiveness. In *Titan Steel Wheels Limited v The Royal Bank of Scotland Plc*⁵²⁷ the court had to interpret the definition of private person provided by the ROA. The ROA provides that a ‘private person’ for the application of s.150 includes ‘any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind’.⁵²⁸ Titan was a steel wheel manufacturer whose earnings were in Euros while its spending was in Sterling. Titan purchased two swap contracts from its banks while it was classified as an intermediary client under the old conduct of business regime.⁵²⁹ Needless to say, Titan ended up with losses and subsequently sued its bank on the grounds that it provided advice to purchase financial products unsuitable for its needs. The court

⁵²⁴ ROA

⁵²⁵ See the case *Titan Steel Wheels Limited v The Royal Bank of Scotland Plc*, (n 407) para 69-70 for the policy reasons behind the restriction.

⁵²⁶ Iain MacNeil, ‘The Evolution of Regulatory Enforcement Action in the UK Capital Markets: A Case of ‘Less is More?’ (2007) 2 CMLJ 345, 362

⁵²⁷ (n 407)

⁵²⁸ ROA, reg.3(1) b

⁵²⁹ The old conduct of business, known as COB, was effective until 2007. Suffice to say, in this case, an intermediary client is similar to the professional client under COBS.

rejected Titan's claims to be treated as private person since its core business was wheel steel: '[t]he fact that Titan's business was not confined to or focused on investment business is not to the point. The regulations expressly refer to the carrying on of business of any kind. This expression should be ... given a wide interpretation'.⁵³⁰ This means that 'the scope of the exception in Reg. 3(1)(b) embraces a corporation which carries on business of any kind even if it does not constitute a regulated activity or something akin to it'.⁵³¹

Irrespective of the conclusion of the facts of the case, this wide approach might lead to further restrictions on the scope of s.150. In a global commercial context where corporations need to trade in different countries with different economic contexts (such as currency), it is plausible for ordinary business to seek protection against changing circumstances by engaging with financial services. Within the UK, the increased emphasis on the integration of the EU single market would reasonably lead corporations of different sizes to seek opportunities abroad. Therefore, there is a need to be involved with financial markets to a certain extent. It follows that the wide interpretation of the court in the *Titan* case would lead most businesses to be considered non-private persons. Accordingly, it is possible to suggest that this narrowing of the interpretation of the court of 'private persons' may reduce the scope of the potential meaning of private persons, and, for the same reasons mentioned above, reduce the effectiveness of s.150.

The subtle role of the regulator (the FSA) may also have influenced the ineffectiveness of private enforcement of regulatory duties in two ways: in the classification of clients and the eligibility of consumers for FOS services.

⁵³⁰ Para 48

⁵³¹ Para 51

It is noted above that the FSA embraces the concept of a classification of customers to determine the appropriate level of protection and to provide the actionability elements of the regulatory rules. These are detailed in Part III of this chapter with respect to suitability and best execution. By reducing the scope of ‘retail consumers’, who are the main focus of most of its substantive regulatory protection, the FSA can influence the effectiveness of private enforcement by extending the protection of the rules to those able to enforce it within the meaning of “private persons” defined by the ROA. While the ROA provides a right on the basis of the characteristic of the person suing, the FSA may further influence those who are entitled to regulatory protection. For example, a corporation that holds net assets of capital of at least 5 million might be considered as a private person but, since it is considered as a professional client according to the COBS,⁵³² the corporation is effectively not entitled to sue on the basis of these rules applicable to retail consumers. Moreover, there is a subtle difference between an investor’s entitlements under ROA and COBS. For an investor to be identified as ‘private person’ someone should look objectively at the characteristics of the investor to determine whether or not the investor is entitled to be classified as ‘private person’. In contrast, the court in *Bank Leumi (UK) plc v Wachner*,⁵³³ pointed out that the duty to classify a client is a duty to take reasonable care in following the criteria in the rule-book:

‘... in determining whether there is "appropriate" classification of a client as an intermediate customer [similar classification to professional] where the classification procedure adopted is under COB 4.1.9 R one does not ask whether the client has the characteristics,

⁵³² See COBS 3.5.2(3) R

⁵³³ [2011] EWHC 656 (Comm)

objectively considered, of an intermediate customer but one instead asks whether COB 4.1.9 R has been complied with'.⁵³⁴

The consequences of the judgement are that it is possible that a retail client would be mis-classified as a professional and hence loses his or her regulatory protection, so long as the service provider can establish reasonable care has been taken in the classification process. Thus, it could be suggested that the FSA is able to influence the effectiveness of s.150 and subsequently private enforcement within the FSMA regulatory regime by determining how clients are properly classified.

The influence of the FSA on the important position of the FOS as a means of the private enforcement of COBS is conferred from the FSMA. The current financial ombudsman was created from the merger of seven ombudsmen that dealt with different aspects of financial services, and the rationale behind establishing a single ombudsman was to reduce the confusion associated with the previous regime.⁵³⁵ The FSMA lays down the objective of the FOS to be a 'scheme under which certain disputes may be resolved quickly and with minimum formality by an independent person to resolve individual disputes between consumers and financial services firms'.⁵³⁶ The institutional arrangement employed by the FSMA dictates that the FOS is independent from the FSA; the FSMA, however, confers to the FSA authority over the FOS, appointing its board members, setting the its rules and determine the cap on

⁵³⁴ Ibid, para 129

⁵³⁵ Charles Rickett and Thomas Telfer, *International Perspectives on Consumers' Access to Justice* (CUP 2003) 167. For more details as to the concept of the ombudsman see Luigi Cominelli, 'An Ombudsman for the European: Gradually Moving Towards "Effective Dispute Resolution" Between Citizens and Public Administration' in Linda Reif (ed.), *The International Ombudsman Yearbook Vol. 6, 2002* (Brill 2004) 144. The Parliamentary Commissioner Act 1967 was the first to introduce the concept of ombudsman into the UK; for the history of the concept of ombudsmen in the UK, see Peter Leyland and Terry Wood, *Administrative Law Facing the Future: Old Constraints and New Horizons* (Blackstone 1997) 90

⁵³⁶ FSMA s.225 (1)

compensation payable.⁵³⁷ In fulfilling its role in determining who is eligible for FOS services, the FSA has published rules and included them in the Complaint Sourcebook (DISP) and the Compensation Sourcebook (COMP) within the Handbook.⁵³⁸

The FOS represents a mechanism for alternative dispute resolution rather than formal dispute resolution. A claim has to start at the firm with which a consumer is alleging breach and cannot be straightforwardly brought to the FOS. The firm has to respond to the claim within eight weeks. If the dispute is not solved between the consumer and the firm, the former can then bring the complaint to the FOS. If the ombudsman upholds the complaint, the firm at fault can be required to make appropriate redress to the complainant.⁵³⁹ After a decision by an ombudsman is made, the decision is binding on a firm although a complainant who does not accept the decision may take the case to court.⁵⁴⁰ If a firm fails to abide by an FOS's award, the FOS will report the firm to the FSA to take action against them.⁵⁴¹ Four criteria are provided through the DISP and the COMP according to which a consumer is able to bring a claim to the FOS: firstly, the type of activity to which the complaint relates; secondly, the place where the activity took place; thirdly, the eligibility of the complainant; and finally, the time limits for referring a complaint to the FOS.⁵⁴² It is the criterion of eligibility which allows the FSA to influence the protection provided by s.150.

⁵³⁷ For the on-going relationship between the FOS and the FSA, see a speech by Clive Briault, 'Markets, Regulation and Disputes' (the International Federation of Financial Ombudsmen Conference, September 2007) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0928_cb.shtml> accessed 29 June 2011

⁵³⁸ Those rules are made pursuant to FSMA Part 16 and Schedule 17

⁵³⁹ FSMA s.228(5)

⁵⁴⁰ Ibid

⁵⁴¹ Memorandum of Understanding between the FSA and FOS, July 11, 2002, para. 17(e)

⁵⁴² For a full discussion and details in respect of those elements and other requirements, see the FSA, 'Dispute Resolution: Complaint' (release number 076, April 2008) <<http://www.fsa.gov.uk/pubs/hb-releases/rel76/rel76disp.pdf>> accessed 29 June 2011

Most importantly, the FSA restrict the awards limits of FOS services to the amount of £100,000. Effectively there are two classes of those who are eligible for FOS services: eligible complainants with awards of less than £100,000, and those with greater awards. These classes enjoy different levels of substantive protection. The differences arise from the FSMA requirement that the ombudsman has to determine complaints with ‘reference to what is, in the opinion of the ombudsman, *fair and reasonable* in all the circumstances of the case’.⁵⁴³ As a result, it is not disputed that no legal precedent binds the ombudsman’s decisions; the approach they take is to decide what is fair and reasonable in the circumstances of each particular case.⁵⁴⁴ The FSA limitation is meant to identify people who can afford to pay for legal services and to have access to justice.⁵⁴⁵

Given the advantages of the FOS, it is then a question of the importance of the FOS for s.150. This can be emphasised in the role of the FOS in bringing claims for a breach of authority rule. Firstly, all eligible complainants are *de facto* private persons in accordance with the ROA; consequently, it is possible to suggest that the FOS permits the application of consumers’ rights according to the ROA. Secondly, if the FOS is the only applicable means for compensation available to the consumer;⁵⁴⁶ it is an impractical proposition for most investors in dispute with financial services firms to bring cases to court, because the balance of financial and legal resources is all on

⁵⁴³ (emphasis added) FSMA, Part XVI, s.228(2). But see s.228(1), which imposes restrictions on extending it to voluntary and credit jurisdictions.

⁵⁴⁴ But it would take into account relevant law and regulations; (2) regulators’ rules, guidance and standards; and (3) codes of practice. DISP 3.6.4 R

⁵⁴⁵ See the FSA, *Review of Compensation Scheme and Ombudsman Service Limits and Miscellaneous Amendments to the Compensation Sourcebook* (Consultation Paper No. 05/15, December 2005) Annex 1, para 31; and also the FSA, ‘Review of Compensation Scheme and Ombudsman Service Limit’ (Policy Statement No. 06/4, June 2006)

⁵⁴⁶ Briault (n 535). The figure is close to another empirical study in Sharon Gilad, ‘Accountability or Expectations Management? The Role of the Ombudsman in Financial Regulation’ (2008) 30 *Law and Policy* 227

one side.⁵⁴⁷ Accordingly, it could be suggested that the FOS permits some consumers, otherwise unable to bring their complaints to courts, to be dealt with and thus helps to enforce the authority's rules in accordance with s.150. This would be based on the fact that there are nearly 300 cases every year which exceed the FOS's cap,⁵⁴⁸ but 'none of the cases that go to ombudsman would actually reach the courts'.⁵⁴⁹

Therefore, it could be maintained that, given that the objective of s.150 is to provide for the enforcement of regulatory rules to private persons (including legitimate complainant) it is therefore possible that the FSA is able, by exercising its rights according to FSMA, to influence the application of s.150 by determining who is eligible and the limits of compensation.

In short, this section has demonstrated how private enforcement is provided for within the FSMA framework of rules introduced by the authority relating to the conduct of business. The private enforcement of COBS has been accommodated through a tort for a breach of statutory duty. However, an action in tort for a breach of statutory duty under s.150 has been restricted to 'private persons' by the FSMA. It is argued here that the means through which private enforcement is provided (i.e. tort for a breach of statutory duty) is ineffective. Bearing similarity to critiques of s.62A of the FS regime, the FSMA provides the right to those who lack the resources to bring an action. The discussion also demonstrates that there have been developments which further reduce the effectiveness of s.150 under the FSMA regime; firstly, the wide interpretation of secondary legislation (namely ROA) by the courts which effectively exclude many business from the definition of 'private person'; and,

⁵⁴⁷ Jeremy Mitchell, 'Response to the Commission Green Paper: Financial services: Meeting Consumers' Expectations' (1997) 20 *Journal of Consumer Policy* 379

⁵⁴⁸ The FSA, *Review of Compensation Scheme and Ombudsman Service Limits and Miscellaneous Amendments to the Compensation Sourcebook* (n 543) para 10.16

⁵⁴⁹ A speech by Tony King, lead ombudsman for pensions and securities at the FOS, (Pensions Management Institute Annual Dinner, February 2006) <http://www.financial-ombudsman.org.uk/news/speech/PM_feb06.htm> accessed 29 June 2011

secondly, the role of the FSA. The FSA has decreased the effectiveness of s.150 by limiting the substantive protection provided by the regulatory rules to retail consumers and by restricting the eligibility of FOS services to certain classes of retail consumers.

E) Concluding Remark

The discussion demonstrates that the private enforcement of the rules has the potential to play a more valuable part of the FSMA regulatory regime. This is demonstrated in two regulatory ways. Firstly, consumers of financial services have been given a direct claim for compensation or restitution against those who are in breach of the General Prohibition. Secondly, consumers are given a claim in case of a breach of the rules of the authority, but here through a cause of action of ‘tort for a breach of statutory duty’. Thus, it could be argued that the FSMA, similarly to the previous FS regime, considers private enforcement a part of its framework.

An account of the role of the FSA in the regulatory regime has also been given. The framework established by the FSMA and the way that private enforcement is accommodated through a tort action puts the FSA at the centre of the private enforcement regime. Mainly, through its requirement of classification, which helps to focus protection on those most in need of it, the FSA is able to restrict and expand the scope of the regulatory rules and subsequently their private enforcement. In other words, by stating that this rule is applied to a particular class of consumers, that is retail consumers, the FSA effectively restricts the actionability of the regulatory rule to this class of consumers.

Returning to the question posed at the beginning of this chapter, what are the problems with the existing law in facilitating civil actions by retail investors? Two problems are suggested with the FSMA regulatory regime.

First, there is inconsistency in the concept of the ‘retail investors’ in the FSMA regime. The secondary legislation, the ROA, refers to ‘private persons’ as a class of investors that enjoys the right to bring an action for a breach of statutory duty; and the rationale for this is to avoid actions based on technical rules. The COBS, in contrast, adopts a different approach to those in most need of regulatory protection, i.e. ‘retail client’. In a different view from the COBS, the FSA considers legitimate complainants for FOS services to be limited upon the basis of the amount of the awards made, in order to identify people who can afford to pay for legal service and to be able to access justice.⁵⁵⁰ Inconsistency of the FSMA regime is not only ascribed to the concept of who is a ‘retail investor’, but also inconsistency in regards to the rationales behind them.

Therefore, it is recommended to adopt a unified concept for ‘retail investors’. A unified concept would reduce levels of complexity, increasing certainty and maintain confidence. The FSMA regulatory regime would have been more effective if consistent concepts between protection and enforcement had been adopted.

One further question needs to be asked, however. Which concept better serves private enforcement in the FSMA regime: private persons, retail consumers or eligible complainant? It is noted above that the restriction of private enforcement to private persons, in order to exclude financial institutions and commercial entities, has been widely criticised on the grounds of the lack of resources to those provided with the right to sue. The approach of the FSA to eligible complainants, a class of consumers who should have better enforcement mechanisms, is evasive as to important considerations concerning its *ratio legis*. Firstly, the justification for the FSA restricting FOS services to a £100,000 cap limit fails to take into account moral and

⁵⁵⁰ See the FSA’s Consultation Paper and Policy Statement (n 535)

economic considerations. Morally, public law scholars recognise two important functions of private enforcement, including ombudsmen schemes, for citizens; the just resolution of complaints and individual grievances, and the “general quality assurance and improvement of private services for citizens”.⁵⁵¹ To link these moral considerations with economic justification has been criticised; how in principle can the FSA morally justify entitlement for ‘fairness’ to certain class of consumers on their economic ability given that providing a cause of action to breach for a provision of securities regulations cannot be justified only on the basis of distributive justice, but also welfare concerns and as a means of regulating contractual relationship.⁵⁵² The approach of the FSA in regards to ‘fairness’, however, arguably undermines certainty, not because of the fairness element itself, but the difficulty in determining whether or not the contract is subject to ‘fairness’ at the time of transacting. Both service providers and consumers are entitled to know the rules that would govern the time of the transaction.

Economically, the approach of the FSA as to the cap limit can be undermined on the grounds the £100,000 cap was set almost 25 years ago by the Insurance Ombudsman Bureau.⁵⁵³ The purchase power of this amount would be between £286,000 and £439,000 in 2010’s value.⁵⁵⁴ Consequently, it could be reasonably claimed that the cap should have been lifted with increases in legal costs, or should at least increase with inflation, in order to maintain its original force as a just rationale.

⁵⁵¹ Gilad (n 544) 228

⁵⁵² Mahmood Bagheri, *International Contracts and National Economic Regulation: Dispute Resolution* (Kluwer 2000) 225-226

⁵⁵³ See the FSA’s Consultation Paper and Policy Statement (n 535)

⁵⁵⁴ The difference in the figures is due to the different methods of calculation. The higher figure is based upon the worth of the money compared to average earning. The lower is calculated on the basis of Retail Price Index. The numbers are obtained from http://www.measuringworth.com/ppoweruk/result.php?use%5B%5D=CPI&use%5B%5D=NOMINAL_EARN&year_late=1981&typeamount=100000&amount=100000&year_source=1981&year_result=2010 accessed 29 June 2011

Accordingly, it could be maintained that approach of the eligible complainant is also inappropriate.

Given that neither ‘private person’ or ‘eligible complainant’ may enhance the value of private enforcement, we are left with the concept of ‘retail clients’ This will be analysed thoroughly later this chapter after an evaluation of the rules themselves in discussion of private enforcement of suitability and best execution in Part III.

The second problem with the FSMA regulatory regime is that few cases have been brought before English courts relying on s.150.⁵⁵⁵ This fact may render any claim for the effectiveness of s.150 questionable. In explaining the low number of actions brought before the courts, it can be argued that consumers are better off bringing their claim to FOS. While it is arguable that the FOS helps to solve consumer complaints, this is not the whole story. As previously discussed there are over 300 cases annually rejected by the FOS because of the monetary cap which are not brought to court. There is no empirical research in the literature on what happens to those cases when they are refused FOS services. Accordingly, it is possible to advance several different explanations. It is possible to suggest that these cases may not have legitimate claims at all; consumers are suing in response to frustration arising from their expectations but there is no breach of regulatory rules. Or it could be suggested that consumers are abandoning their claims. Obstacles in pursuing claims could include the expense and time consumed in enforcing their rights, or the complexity of the laws. The Law Commission suggests it’s the latter and claims that consumers are faced with the task of attempting to establish ‘a complex and novel action for breach of statutory duty before the courts’.⁵⁵⁶ Alternatively, it could also be

⁵⁵⁵ See for example *Spreadex Ltd v Sekhon* [2008] EWHC 1136 (Ch)

⁵⁵⁶ The Law Commission, *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Insurance Contract Law Papers, n.6, 2010) para 5-18

maintained that the low number of cases is due to the fact that consumers, or the majority of them, are settling their claims with financial services providers.

These explanations are difficult to test because the FOS refuses to publish the details of cases. Nevertheless, Part III below provides a detailed analysis of the law regarding suitability and best execution from a regulatory perspective, and thus will be of help in providing a conclusion concerning which explanation is most accurate. Moreover, another expected benefit of analyzing the regulatory rules is to test how the COBS measures up to the expected benefits of the statutory framework. To rephrase the benefit, it is to answer the question whether or a preferred instrument to achieve a desired policy (here, investor protection by setting standards) is affected by the way that the instrument (private enforcement of the COBS) has been implemented (i.e. through tort of breach of statutory duty).

Part III Best Execution and Suitability

A difficulty arises when attempting to examine the whole sets of rules introduced by the regulatory regime that are supported by private enforcement. Given the restriction of both time and the space in this study, its examination needs to be restricted to the comparison between the two case study countries and therefore two regulatory duties have been chosen for detailed analysis: the duty on financial advisers to provide suitable financial advice; and, the duty imposed on financial providers in general, and brokers in particular, to ensure the best execution of an investor's order.

These duties have been chosen on the basis that the IOSCO promotes them as best standards for regulatory protection for investors in securities markets. It is thought that since 'suitability' and 'best execution' represent a global consensus of

proper regulatory instruments to protect investors in securities markets, they supply the most appropriate comparative element in the analysis of the UK and Saudi Arabia.

Consequently, the way these global standards have been implemented dictates how the discussion is approached. As regulatory requirements, both suitability and best execution as regulatory requirements are imposed through the COBS introduced by the FSA. Part II of this chapter demonstrates how the FSMA established the private enforcement of COBS rules through s.150. It is noted moreover that, notwithstanding historical observations of its weakness as a private enforcement technique, the tort of 'a breach of statutory duty' is the chosen means for implementing private enforcement of COBS rules. That being the case, it is illustrated that the added benefit of a regulatory duty in tort for a 'breach of statutory duty', in contrast to traditional tort actions, is in providing a more detailed picture of what an existing duty entails, introducing a new duty not recognised under tort law, or both. It follows that it could be argued that the expected benefits of suitability and best execution as regulatory requirements for private enforcement might be in providing more details of an existing duty under tort law, introducing duties which were not previously recognised, or indeed both of these factors. Otherwise, in the absence of any of the expected benefits, it could be reasonably claimed that the means chosen by the regulatory regime (i.e. tort for a breach of statutory duty) to enforce suitability and best execution is not effective in the sense that it does not add any additional benefits for private enforcement over a traditional tort action.

In the light of this, the two duties are now examined with two objectives: firstly, whether or not the two cases of suitability and best execution have introduced novel duties not previously recognised under private law; and second, in case this first objective is not met, whether or not consumers are better off suing under s.150 as a

result of the detailed pictures of duties introduced by the COBS. Required in this analysis are details of what each duty entails in COBS and to compare these with a similar duty recognised under English private law. For the sake of clarity, each duty is examined separately.

A) The Regulatory Requirement of Best Execution

In Part I d, it was demonstrated that the concept of best execution was initially developed in case law in the U.S. It was also in the US where it was first introduced as a regulatory requirement to deal with the fragmental securities markets there. The discussion also covered the historical development of the regulatory concepts of best execution in the UK, illustrating the relation between the nature of the concept with developments in financial services.

Under the current FSMA regulatory regime, there is an emphasis on the importance of best execution in COBS with regards to relationships between consumers and service providers. COBS states that a ‘firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients’.⁵⁵⁷

COBS constructs the concept of best execution around several factors and criteria.⁵⁵⁸ The Glossary lists ‘execution factors’ as including price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to execution.⁵⁵⁹ As spelled out in the Glossary, execution criteria deal with the judgemental requirement of best execution. These criteria are: the characteristics of

⁵⁵⁷ COBS 11.2.1 R. The term execute defined by the Glossary: to ‘carry into effect or perform the transaction, whether as principal or as agent, including instructing another person to execute the transaction’.

⁵⁵⁸ COBS 11.2.1 R and see also 11.2.6. R

⁵⁵⁹ See the Glossary under ‘execution factors’

the client (retail or professional),⁵⁶⁰ the characteristics of the client order,⁵⁶¹ the characteristics of the financial product or instrument being executed,⁵⁶² and characteristics of the venue through which the order is executed.⁵⁶³ COBS clarifies that the importance of execution criteria is to help authorised firms in ‘determining the relative importance of the execution factors’.⁵⁶⁴ It should be emphasised that there are other duties imposed on authorised firms in complying with best execution, including, for instance, to have an ‘execution policy’ and to not structure the charges in order to discriminate against ‘execution venues’.⁵⁶⁵

It should be noted that while these requirements are imposed in dealing with all classes of consumer, the COBS provides certain rules that restricted certain of their protections to ‘retail clients’ only. Firstly, in dealing with retail clients, authorized persons are required to prioritize the total consideration of the execution; i.e. the price paid for the instrument executed in addition to costs associated with executing the order.⁵⁶⁶ Secondly, in executing a retail client’s order, an authorised firm must ensure that, before execution, the retail client is informed about the relative importance assigned to each factor, the different executing venues that the authorized firm deals with, and that any specific instructions from the client may prevent the best execution as provided in the execution policy.⁵⁶⁷

These added two protections for retail clients demonstrate how the FSA can influence through COBS the scope of private enforcement. Other measures provided under best execution in effect permit all consumers who are considered to be private

⁵⁶⁰ COBS 11.2.6R (1)

⁵⁶¹ COBS 11.2.6R (2)

⁵⁶² COBS 11.2.6R (3)

⁵⁶³ COBS 11.2.6R (4)

⁵⁶⁴ COBS 11.2.6 R

⁵⁶⁵ COBS 11.2.12 R and 11.2.14R, respectively

⁵⁶⁶ COBS 11.2.7 R and 11.2.8 G

⁵⁶⁷ COBS 11.2.23R

persons to sue in accordance with s.150. But the specific limitation to retail clients in the two added protections effectively restricts the actionability of the rules to those considered as retail clients.

Overall, there are two general observations as to the regulatory concepts of best execution as currently implemented in COBS.

Firstly, the concept of best execution has departed from the concept of best execution in the US. In the UK, it is confined to giving guidance on how an authorized firm can decide what best execution is. It leaves it to the firms themselves to decide what the most important factor is and to prioritise among these factors, bearing in mind that in dealing with retail clients, an authorized firm has ‘to determine the best possible result *in terms of the total consideration*’.⁵⁶⁸ The focus on total consideration represents a shift in the regulatory understanding of the concept of best execution. In the previous conduct of business book (a.k.a. COB),⁵⁶⁹ best execution entailed two duties; firstly, a service provider should take reasonable care in determining the best available price in the market ‘for transactions of the kind and size concerned’,⁵⁷⁰ and secondly, should ‘execute the customer order at a price which is no less advantageous to the customer, unless the firm has taken reasonable steps to ensure that it would be in the customer's best interests not to do so’.⁵⁷¹ In contrast to COBS, where there is emphasis on ‘total considerations’, the COB permitted service providers, in exercising reasonable care in determining the best available price, may disregard any commission or charge by the service provider so long as it had been disclosed to the customer.⁵⁷² Moreover, COBS has a wider scope in its application in comparison to COB, which exempted from best execution certain structured products

⁵⁶⁸ (emphasis added) COBS 11.2.32R

⁵⁶⁹ COB was in force until 31/10/2007

⁵⁷⁰ COB 7.5.5(1) R

⁵⁷¹ COB 7.5.5.(2) R

⁵⁷² COB 5.5.6.(1) E

and focused on executing deals in shares and other financial securities.⁵⁷³ There is no such exception in the COBS.

In contrast, the concept of best execution in the US is more akin to COB, emphasising securities and spelling out what reasonable care is for a broker.⁵⁷⁴ The difference could be attributed to the fact that scope of the FSA and subsequently COBS is wider, including other investments and not being confined to securities. That being said, the difference supports the claim that there could be different interpretations and perceptions of what the regulatory duty of best execution entails among geopolitical entities.

Secondly, as implemented, best execution seems to be based on the ideology of consumer choice rather than the expertise and knowledge on the part of a service provider. Specifically, the emphasis is organised around consumer consent; for instance, it is acceptable that an aggregate order will be disadvantageous for a client so long as the consumer provides consent.⁵⁷⁵ Though aggregation rules will be influenced and should be guided by the best execution rule, its introduction under the heading ‘client order handling’ rather than ‘best execution’ suggests one of two things.⁵⁷⁶ Either the FSA perceives best execution to be wider in scope than being limited to shares in secondary markets, or it perceives the relationship between a consumer and a provider of the execution service as a matter of competing options before consumers.

On balance, it is likely that the latter explanation is more accurate, since in COBS guidance and examples of how to implement best execution reference is made

⁵⁷³ See for example COB 7.5.4 R

⁵⁷⁴ See FINRA Rule 2320. Best Execution and Interpositioning (effective until may 2011)

⁵⁷⁵ COBS 11.3.7 R

⁵⁷⁶ COBS 11.3

to ‘shares’.⁵⁷⁷ In addition, accepting that a service provider has obtained retail clients consent for a disadvantageous execution means that the duty to consider the best interests of the client imposed by best execution rules is cancelled out. Moreover, the focus of the FSA on the importance of the interaction between consumer choice and market forces could be deduced from the COBS demand that an authorised person should not structure the commission and charges in such a way as ‘to discriminate unfairly between execution venues’.⁵⁷⁸ This emphasis by the FSA on not intervening in market forces and consumer choice gives support to the claim that the FSA has implemented the doctrine of best execution using the concept of consumer choice.

So far, this discussion illustrates that under the duty of best execution, the COBS requires authorised persons, when dealing with retail clients, to prioritize the total consideration of the execution, i.e. the price paid for the instrument executed in addition to costs associated with executing the order.⁵⁷⁹ However, the consumer consent may relieve the service provider from seeking the best interests of a retail client in respect of some duties. Consequently, it could be suggested that the regulatory requirement of best execution in COBS provides a detailed account of the duty and hence supplies a benefit for a claim for a breach of statutory duty.

The second claimed benefit of the statutory framework as to a tort of breach of statutory duty is to provide a novel duty which did not previously exist in tort law. Thus, the issue is whether or not English private law had recognised a duty similar to the requirement of best execution.

The discussion in Part I demonstrates that the regulatory requirement of best execution developed from common law and agency principles in the US. English law recognises the importance of agency relationships and provides numerous principles

⁵⁷⁷ COBS 11.2.5 G

⁵⁷⁸ COBS 11.2.12 R

⁵⁷⁹ COBS 11.2.7 R and 11.2.8 G

governing the relationship between a principal and an agent through equity and fiduciary duty. In fact, before the introduction of the FS regulatory regime, relationships between firms and clients were regulated, according to Benjamin, primarily by the rules of equity.⁵⁸⁰

According to equity principles, whenever there is a relationship of trust between two parties, fiduciary duty arises even in commercial transactions.⁵⁸¹ The significance of fiduciary duty is its ability to create ‘obligations of a different character from those deriving from the contract itself’.⁵⁸² The significance of fiduciary duty to the discussion is that it imposes an obligation on an agent to act in the best interests of the beneficiary of the fiduciary relationship (the duty of loyalty). In *Aberdeen Railway Co v Blaikie Brothers*, the court noted that

‘[A fiduciary will not be permitted] to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect’.⁵⁸³

To be more specific, equity recognises that stock-brokering involves a level of trust between the broker and the investor, at minimum to recognise an agency between the two parties. A stockbroker, in an execution only transaction, is considered as an agent with specific instructions which imposes on the broker the duty, *inter alia*, to act all times in the best interest of the client, not being permitted to deal as a principal with the client, and not able to make a secret profit whether or not

⁵⁸⁰ Benjamin (n 356) para 26.50

⁵⁸¹ Ibid, see also Paul Finn, ‘Fiduciary Law and Modern Commercial World’ in Ewan McKendrick (ed.), *Commercial Aspects of Trusts and Fiduciary Obligations* (Clarendon press, the Norton rose M5 group 1992) 9; Rupert Jackson and John Powell, *Jackson & Powell on Professional Liability* (Sweet & Maxwell 2007) para 15-042

⁵⁸² *Goldcorp Exchange Ltd (in receivership), Re sub nom Kensington v Unrepresented Non-allocated Claimants Neutral Treatment Indicated* [1995] 1 AC 74, 98

⁵⁸³ [1854] 1 Macq 461, 471

it is at the expense of the client.⁵⁸⁴ Taking these together, it could be maintained that, under English private law, stockbrokers were held to look for the best interest of the client; what best is for a client will depend on the circumstances and the context of the relationship between the parties.⁵⁸⁵ Consequently, it could be argued that, through best execution, COBS does not introduce a novel duty that has not been recognised previously under English private law.

Accordingly, it could be reasonably claimed that the benefit from the best execution in COBS is confined to spelling out the duty in detail in such a way as to facilitate private enforcement.

However, once the discussion of best execution is focused on retail clients, the role of private enforcement diminishes. The problem arises from the recognised problem that the small losses associated with breaches of ‘best execution’ create no incentive for consumers, especially retail ones, to sue.⁵⁸⁶ For this reason, the notion of best execution was developed in the US through regulatory oversight and class-action suits rather than direct legal action by investors.⁵⁸⁷ On re-examination, there is nothing in the UK that is successfully similar to the U.S. class-action system that could support the application of best execution. Moreover, placing the cause of action of s.150 through tort remedies results in the reliance on the concept of compensation rather than deterrence; thus, it is impossible to expect any sort of punitive damages to be awarded to consumers. In contrast, the Securities and Exchanges Act 1934 in the

⁵⁸⁴ See *Rothschild v. Brookman* (1831) 2 Dow. & Cl. 188; *Bristol and West BS v. Mothew* [1998] Ch.1 at 18. But see the case *Western Insurance Company of New York v. Culiffe* (1874) Ch.app525, where it was ruled that it is acceptable if it was clear to the principal that the agent will be remunerated by the others as a matter of business.

⁵⁸⁵ The scope of duties and what the duty entails in a particular relationship will depend on all circumstances, including the contract, which create a relationship of trust and confidence; see Jackson and Powell (n 579)

⁵⁸⁶ Facciolo (n 374)

⁵⁸⁷ *Ibid*, ‘[n]o individual investor would have an incentive to pursue such small losses. Only a regulator or an attorney able to recover fees from a common fund would have the resources to pursue such a claim’, 159

U.S. did not provide for punitive damages for breaching a regulatory rule, but this was permitted later.⁵⁸⁸ Accordingly, given the absence of a class-action system and punitive damages in the UK, it is the public enforcement, through the FSA, which is the principal means to enforce best execution. It is unlikely that retail clients would bring an action, even to FOS, for breaching the best execution rule.

The narrow scope of private enforcement and the reliance on the regulator's role create three difficulties that may undermine the effectiveness of the concept of best execution. Firstly, there is a possibility of lax enforcement by the regulator as a result of lack of resources and/or regulatory captures by the service providers. Secondly, the perception of the regulator as to what constitutes best execution may not represent the best protection available to investors, or worse, it may prevent retail investors from enjoying the protection provided by private law. The School of Law and Economics law clearly spells out the conflict of two conflicted objectives that constrain public enforcement. Macey and O'Hara analysis points out that common law of agency, which includes fiduciary duty and loyalty, asks an agent to act in the best interest of the principal with reasonable care.⁵⁸⁹ A stockbroker in case of a retail investor, therefore, is legally required to try to obtain the best price, but may not actually obtain it, although the duty of loyalty and fiduciary duties demand a sole duty towards the principal. However, attempts by regulators to re-define this relationship resulted in including a duty toward the market by allowing the aggregation of orders to be driven to where trading benefits competition among exchanges, in contrast to

⁵⁸⁸ Phillip Johnson and Thomas Hazen, *Derivatives Regulations* (Aspen 2004) 1453. For a policy discussion as to the need for punitive damages in securities regulations see Note, 'Securities Regulation--Damages--The Possibility of Punitive Damages As a Remedy for a Violation of Rule 10b-5' (1970) 68 Mich. L. Rev. 1608; William Walker, 'Punitive Damages for Securities Regulation' (1970) 8 Hous. L. Rev. 137

⁵⁸⁹ Macey and O'Hara (n 375)

the individualistic approach imposed by common law that aggregation should provide better price wherever possible.⁵⁹⁰

Finally, regulatory techniques can divert best execution from its principal objective for which it was developed as a regulatory rule. Viewing the relationship between investor and broker as a matter of choice does not fit with agency law which focuses on the loyalty and trust between a principal and agent. Thus, in the absence of a private enforcement, a mistaken regulator view will dominate without correction. Such changes will result in inappropriate techniques being adopted to implement best execution that may reduce the protection provided by traditional law. For similar reasons, Benjamin criticises the focus of the regulatory regime on disclosure in relationships where confidence and trust are the incentive to seek the service.⁵⁹¹

For the previous mentioned reasons, it could be argued that the absence of private enforcement may negatively influence the expected benefit of the regulatory rule of best execution. Given the absence of incentive to protect investors to privately enforce the duty, it could be argued that within the context in which it is implemented, the regulatory duty is ineffective to be privately enforced or to increase the protection for retail clients.

To sum up the discussion, it is suggested that COBS does not introduce a novel duty to English private law through best execution since it has been recognised under English law through agency law, namely in the loyalty and best interests of the principal. Through best execution, the COBS does provide fair guidance and details as to how to comply with best execution rule in dealing with retail clients: ‘to determine the best possible result in terms of the total consideration’. However, it is argued that the issue with private enforcement is that a breach of best execution rule

⁵⁹⁰ Ibid, ‘the SEC has re-interpreted the duty of best execution as a general duty to the markets, rather than as a particularized contractual obligation between market participants’, 50

⁵⁹¹ Benjamin (n 356) para 25.23

does not create an incentive to sue; the losses suffered are minimal in the context of retail investors. Accordingly, it is claimed that private enforcement of ‘best execution’ rule in the UK context will not be effective due to the absence of both the concept of punitive damages and class-action suits. It is also noted the need for private enforcement is vital and suggested that relying on public enforcement alone as it stands now would have severe negative consequences. For these reasons and from the analysis in part II of the effectiveness of s.150, it could be justly asserted that the regulatory rule of best execution as implemented by the FSMA regulatory regime is ineffective in increasing the protection of investors needed to enhance the efficiency of the market.

B) The Regulatory Requirement of Suitability

The previous section demonstrates that the regulatory requirement of best execution is ineffective in enhancing the role of private enforcement of the rule, even though it meets one of the criteria concerning the benefits expected from tort for a breach of a statutory duty. The root of this ineffectiveness is the lack of the incentive for individuals to enforce the rule because of the minimal amount of losses. This section attempts to evaluate and examine the regulatory rule of suitability as implemented in the COBS in enhancing private enforcement.

Part I illustrates that the importance of suitability arises from its role in financial advice. Historically, the concept of suitability was developed in response to the mis-selling techniques used by stockbrokers in the ‘boiler room’ and was intended to ensure that shares being sold meet the objectives and needs of the person to whom it is recommended.⁵⁹² It follows that the provision of recommendation is a necessary condition for the application of the regulatory requirement of suitability, and since

⁵⁹² See Part I, d

suitability is implemented through COBS, it is therefore necessary to identify what financial recommendation is, according to the COBS, which entails suitability.

The COBS adopts the terminology of ‘personal recommendation’ rather than financial advice or financial recommendation with respect to suitability.⁵⁹³ The COBS clearly states that suitability applies to a ‘personal recommendation’ in relation to a designated investment.⁵⁹⁴ The Glossary defines a personal recommendation for the purpose of COBS as a recommendation that takes into account the specific circumstances of the person, or which is presented to the client as suitable. It excludes any recommendation passed on through other distribution channels or to the public at large.⁵⁹⁵ The term ‘designated investment’ is wide enough in the Glossary to include securities, structured products, and even interests or rights to those investments.⁵⁹⁶ Therefore, it could be asserted that financial advice that entails a suitability rule is any recommendation in relation to a designated investment, including shares, that takes into account the circumstances of the person to whom it is supplied, or which presented to the client as suitable.

However, COBS stops short from detailing how this would be applied in practice; such as how to differentiate between a sale process that appeals to the need of an investor, and a ‘personal recommendation’ that entails suitability. The parameter deduced from the definition of personal recommendation to determine its characteristics in the Handbook is twofold: firstly, to provide advice on investments ‘based on a consideration of the circumstances of that person’, and secondly, the

⁵⁹³ Probably to differentiate between ‘published recommendation’ and research recommendation’

⁵⁹⁴ COBS 9.1.1. R

⁵⁹⁵ The Glossary’s exact definition: ‘a recommendation that is advice on investments, or advice on a home finance transaction and is presented as suitable for the person to whom it is made, or is based on a consideration of the circumstances of that person. A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public’.

⁵⁹⁶ The Glossary. Note that this wide view of ‘designated investment’ is not chosen by the FSA but is supplied by the secondary legislation, namely the Order.

advice ‘is presented as suitable for the person to whom it is made’.⁵⁹⁷ These two conditions do not clearly state the line between an advice that is a ‘personal recommendation’ for the purpose of COBS from other financial advice or sales process. As to the latter criteria, it is difficult to believe that such a detailed explanation, tendered to a retail investor, would be any different from a straightforward recommendation.

Moreover, as to the former criteria for personal recommendation, an advice on investments based on a consideration of the circumstances of that person, it is unclear what level of consideration would amount to ‘personal recommendation’. There is even inconsistency within the overall regulatory regime as to the subject. Certain actions by the FSA imply a view of financial advice subject to the General Prohibition is different from those in the COBS. For instance, in *Re Market Wizard Systems (UK) Ltd*,⁵⁹⁸ the court held that a provider of advice generated by an automated system needed to be authorised by the FSA. In brief, Market Wizard supplied daily prices and other information to the customer via a modem link that had to be downloaded and entered by the customer. The system operated by producing ‘buy’, ‘sell’ or ‘hold’ signals in respect of options in each of twelve traded stocks. Although these signals did not indicate the amount of stock to be bought or sold, they did show the customer the current positions that should be held on that day. The way that the program analysed the data was a major factor in the court’s conclusion to recognise a financial advice: ‘guidance as to the course of action which the [client] should take in relation to the buying or selling of investments ... in the ordinary use of English, is ‘advice on the merits’ of purchasing those investments’.⁵⁹⁹ It could be noted that the reasoning

⁵⁹⁷ The Glossary

⁵⁹⁸ [1998] 2 B.C.L.C. 282

⁵⁹⁹ Ibid, para 34. Similar views as to financial advice were taken in *JP Morgan Bank (formerly Chase Manhattan Bank) v Springwell Navigation Corp* [2008] EWHC 1186 (Comm), para 107

of the court is based on the linkage not between guidance given and an investor's needs, but to the portfolio of investors being linked to market movement. Such view represents a very broad understanding of financial advice since it is based on very limited data provided by investors about their strategy or risk preferences. It is unclear whether or not the FSA is of the view that such wide interpretation is restricted to advice generated by automated machine or to all kind of advice.

This wide approach is impractical and its impact in practice is undesirable and hence it is unlikely that the FSA is to extend it to advice that constitutes personal recommendation that entails suitability. Suppose a website asks for certain general information about a customer (age, gender, marital status and income) and asks for a preferred strategy (low-medium-high) and then suggests certain products for the customer to consider in the process of selling and promotion. According to this broad view, the website may have provided financial advice subject to regulatory protection (personal recommendation) and hence subject to suitability. Thus, whether or not the information collected justifies the recommended products is very unclear given the lack of guidance by the FSA. It is reasonable to expect the more risky and the more complex the products, the more information needed to be gathered. But whether the law imposes a certain level of information or failure to collect such information entitles the investor to seek remedy for 'personal recommendation' generated automatically is an unclear area within the FSMA regulatory regime. In the age of new media for communications, such as the Internet and sophisticated mobile phones, courts, consumers and businesses need regulatory requirements to be spelled out as to when rules are applicable. This issue of financial advice is not dealt with in the FSA's

documents or scholarly writing, but similar concerns have been raised with respect to the FSA's approach in its adoption of the concept of 'treating customer fairly'.⁶⁰⁰

In principle, there is nothing wrong with this approach, since it is within the remit of the FSA, but there is a possibility of different treatment between financial advice that requires the obtaining of permission, which is the wide approach, and a narrower approach to financial advice for the purpose of private enforcement. In such a case, there would be two tiers of financial advice regulated by the FSMA regime; one tier subject only to public enforcement by the FSA, and another subject to both private and public enforcement. The two kinds of systems would forsake the benefits of private enforcement and increase uncertainty.

The limited case law in relation to financial advice and suitability creates difficulties in affirming or negating the existence of two tiers of financial advice. Nevertheless, two court cases may help to clarify the position. The first is *Investors Compensation Scheme Ltd v. West Bromwich Building Society*,⁶⁰¹ which concerned the mis-selling of a Home Income Plan. The defendant argued that the representation made to the claimant as to the return was nothing more than predictions as to the likely future performance of the plan, and hence was not actionable. The court rejected this argument on the basis that when the defendant made the predictions, it was implicitly stated that these could be justified on reasonable grounds. Thus, the court was of the opinion that advice was provided and held the salesperson accountable. It is therefore possible to suggest that English law considers using predictions as a means to match financial products to the investor's needs as a financial advice.

⁶⁰⁰ See for example Jenny Hamilton, 'Negligence in the Corridor? The Interaction Between 'Separate Rooms' of Regulation and the Common Law in Financial Services' (2007) 23 PN134

⁶⁰¹ [1999] Lloyd's L.Rep P.N. 496

The other case is *Walker v Inter-Alliance Group Plc (In Administration)*⁶⁰², where the salesperson maintained that if he was in the claimant's position, he would transfer from the occupational scheme to a drawdown scheme. The claimant followed this advice which subsequently resulted in a loss because of changing schemes. The court found that a statement about what the seller would do in the consumer's position amounted to more than a neutral way of providing information.⁶⁰³ Similarly to the approach of the court in *Re Market Wizard Systems (UK) Ltd*, the court in *Walker* considered as financial advice 'any communication with the client which, in the particular context in which it is given, goes beyond the mere provision of information and is objectively likely to influence the client's decision whether or not to undertake the transaction in question'.⁶⁰⁴

What the two cases do illustrate is the willingness of courts to recognise financial advice that entails suitability, even in absence of advisory contracts between a consumer and a provider. Although they support the application of a wide approach to private enforcement, one must be cautious in reaching that conclusion from such limited cases. The Market Wizard case is not concerned with private enforcement as much as public interest in winding up the company. This discussion has demonstrated a missed opportunity for the COBS to enhance certainty needed by both business and investors. After all, a right to sue according to s.150 is a tort action, and under English law not every careless act or fault on the part of a professional gives rise to liability in tort in general and negligence in particular, even where others sustain damages as a result. In general, it is necessary for a claimant to satisfy the court that, *inter alia*, a duty of care exists towards the claimant by the provider and the behaviour of the defendant falls below the standard of care imposed by law. Given that suitability

⁶⁰² [2007] EWHC 1858 (Ch)

⁶⁰³ Ibid, para 96

⁶⁰⁴ (emphasis added) *ibid*, para 97

necessitates financial advice to be imposed, and courts are willing to recognise financial advice regardless of contractual terms, it could be argued that a clarification of when ‘advice’ is provided could facilitate the private enforcement of suitability as well as enhance the certainty.

Moreover, the scope of suitability is hindered by the different regulatory regimes for ‘personal recommendation’. As the law currently stands, the COBS requires that every ‘personal recommendation’ be suitable.⁶⁰⁵ COBS thus applies suitability to clients irrespective of the category of the recipients of financial advice; for instance whether a retail or professional client. However, the COBS exempts an authorised person, which is not an advisory but which recommends a stakeholder product, from the suitability requirement. Such an authorised person must follow a different protection scheme called ‘basic advice’ which is available for a retail client only.⁶⁰⁶ The main distinction here is that the FSA considers basic advice as ‘a process that involves putting pre-scripted questions to a retail client’.⁶⁰⁷ Accordingly, not every personal recommendation needs to be individually suitable. This approach in the COBS may narrow the level of the quality of recommendation expected from financial advice by investors. It is likely that the two regulatory frameworks would forsake the benefits of private enforcement in supporting public enforcement in enhancing the quality of services provided.

Subsequent to the establishment of financial advice that entails suitability, consumers need to know whether or not a service provider has fulfilled the suitability rule under the FSMA regulatory regime. As far as this issue is concerned, the COBS provides certain criteria to be taken into account by financial advisers in complying with the duty of suitability. Financial advisers are required to have regard to specific

⁶⁰⁵ COBS 9.1.1R

⁶⁰⁶ COBS 9.1.2.R

⁶⁰⁷ The Glossary

information that has to be collected from the client.⁶⁰⁸ This may be: (a) knowledge and experience in the investment field relevant to the specific type of designated investment or service; (b) the client's financial situation;⁶⁰⁹ and (c) the client's investment objectives.⁶¹⁰ Certain information about the objective has to be collected, such as the length of time a consumer wishes to hold investments, his/her preference regarding risk taking and risk profile, and the purpose of the investments.⁶¹¹ The adviser may be obliged to collect further information depending on the nature of the transaction and consumer's objectives. For example, a series of transactions that are each suitable when viewed in isolation may be unsuitable if the recommendation or decisions to trade are made with a frequency that is not in the best interests of the client.⁶¹² In finalising the advisory process, the COBS requires financial advisers to supply a suitability report for any suitable financial advice provided to retail clients.⁶¹³

The previous paragraph summarizes the regulatory requirement of suitability as implemented by the COBS which illustrate certain characteristic of suitability. The COBS approach leads to many questions worthy of discussion.

Firstly, the COBS implements the concept of suitability in very broad terms and in a different manner from the US, where it was originally introduced. There, suitability implies three things: (1) customer specific suitability, (2) reasonable basis suitability, and (3) quantitative suitability. The COBS does not construct suitability in that way but, nonetheless, recognises suitability as a broad concept that entails different criteria for judgement which are similar to customer specific suitability in

⁶⁰⁸ See COBS 9.2.1 R, and also the case *Marti v. Britannia Life Ltd* [2000] Lloyd's Rep. P.N. 412, at 429, where the judge criticises the adviser who did not consider the affordability of the product.

⁶⁰⁹ It must include, where it is relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments; COBS 9.2.2 R(3)

⁶¹⁰ COBS 9.2.2. R (2)

⁶¹¹ COBS 9.2.2. R (2)

⁶¹² COBS 9.3.2. G, (1)

⁶¹³ COBS 9.4.1 R

the US. This can be illustrated by the fact that there is nothing in the COBS about reasonable basis suitability. The COBS does recognise, however, quantitative suitability, but, unlike the way that the US regulatory regime identifies it as a separate pillar of suitability. Instead, COBS identifies quantitative suitability as guidance to advisers in assessing suitability. As a result, it could be claimed that the concept of suitability in the UK is different from the U.S.

Secondly, in dealing with suitability, COBS puts an emphasis on procedures rather than content, providing a list of the minimum of information needing to be collected from consumers before providing a 'suitable personal recommendation', and imposing a duty to provide a suitability report after providing this recommendation. There is nothing, however, concerning the content of the actual recommendation. Paradoxically, where the COBS provides direction as to the content of the recommendation, this takes the form of guidance rather than actionable rules. Consequently, given that guidance in the Handbook is not actionable in accordance with s.150, it could be argued that in the view of the FSA, private enforcement of the regulatory duties of the content of the personal recommendation is not part of the FSMA regulatory regime.

Thirdly, there is nothing in the suitability rule that attempts to ensure that suitability is provided to a retail client receiving financial advice under the rule itself. For this reason, there is a need to refer to other rules; namely those concerning the client's 'best interest'.⁶¹⁴ The client best interest rule states that a firm 'must act honestly, fairly and professionally in accordance with the best interests of its client'⁶¹⁵ which is applied to any "designated investment business carried on: (a) for retail

⁶¹⁴ COBS 2.1.1 R

⁶¹⁵ COBS 2.1.1 (1) R

client”.⁶¹⁶ Thus, a firm must not seek to exclude, restrict or rely on an exclusion or restriction clause with respect to ‘any duty or liability it may have to a client under the regulatory system’.⁶¹⁷ The absence of an emphasis in the COBS on the availability of suitability to retail clients is inexplicable, since: (1) previous experience in the UK, namely with the pensions mis-selling, indicates the importance of suitability for retail clients,⁶¹⁸ and (2) conflict is possible between a client and an authorised person as to the correct categorisation of a client.⁶¹⁹ The extensive protection provided by the COBS to retail client including the exclusion of liability combined with the way ‘retail client’ is defined passively by defining other categories, creates an incentive for a client to claim mis-categorisation. Given private enforcement under s.150 is restricted to ‘private person’, it is reasonable to expect that ‘private persons’ who really can exercise an action under s.150, because of their resources and financial means, will seek being categorised as retail clients for the purpose of an action under s.150. It would have been a better approach to avoid such complexity to maintain the suitability of the advice within the rule itself. Accordingly, it could be argued that retail clients interests would have been better served by insisting on their right to receive suitable advice clearly, and to identify those who are eligible for this entitlement, at least as far as suitability is concerned.

Finally, there is the the absence of measures in the COBS to gauge the suitability of a personal recommendation in the hands of retail clients. Because of that, courts need to refer to and seek help from expert witnesses.⁶²⁰ It goes without saying that there would be expert witnesses on both sides; but the point to be

⁶¹⁶ COBS 2.1.1(2)a R

⁶¹⁷ COBS 2.1.2 R. But see COBS 2.1.2(1) G that permits exclusion or restriction in case ‘it is honest, fair and professional for it to do so’.

⁶¹⁸ See text to n 466

⁶¹⁹ See for example *Titan Steel Steel Wheels Limited v The Royal Bank of Scotland Plc*, (n 407)

⁶²⁰ *McMeel and Virgo* (n 3) 369

illustrated here is that retail clients are not able to determine with certainty before suing or complaining if there had been a breach of the suitability rule.

Consequently, it could be suggested that the COBS does not provide a detailed picture that permits the easy invocation of the suitability standards as a foundation for redress by retail clients. Such a claim is based on the broad terms that suitability is defined, COBS focuses on procedures rather than content, not ensuring that suitability is maintained in dealing with retail clients within the rule itself, and not providing measures to gauge the suitability of a ‘personal recommendation’ provided.

Given that the COBS does not provide a detailed picture of the duty of suitability, ‘personal recommendation’, the only benefit that could be claimed about suitability enforced through s.150 is that the COBS introduces a novel duty that was not previously recognised under English private law. But this benefit could be rejected since cases that dealt with financial advice before the introduction of suitability in the FS regulatory regime recognised suitability; for example the case *Woods v. Martins Bank Ltd*,⁶²¹ detailed in Part I of this chapter.

Therefore, it could be argued that the FSMA regulatory regime is not clear as to: (1) what constitutes ‘personal recommendation’, (2) what kind of ‘personal recommendation’ calls for the duty of suitability, and (3) what the doctrine of suitability really entails. It is reasonable to maintain that, as far as private enforcement by a retail investor is concerned, suitability as implemented by COBS and the FSMA under s.150 is of limited effectiveness for enhancing private enforcement.

However, it is claimed that suitability as a regulatory requirement may enhance the protection of investors by facilitating an action in misrepresentation. Powell provides the convincing explanations of the effect of the regulatory regime on

⁶²¹ [1959] 1 QB 55 (Ch. Div.)

misrepresentation. Powell links a suitability requirement to misrepresentation by proposing that suitability itself involves three representations:⁶²² (1) the nature of the investment has been carefully considered by the adviser, (2) the investor's needs have been carefully assessed by the adviser, and (3) the recommended investment meets the customer's needs.⁶²³ In articulating the three implicit representations of the suitability requirement in this way, Powell is able to forcefully argue that the regulatory regime provides better protection since consumers do not need to prove the unsuitability of the advice to succeed. A consumer, according to Powell, needs to prove one of the following: (1) the investment recommended is not an investment to be recommended by any adviser (as in the first requirement of the doctrine of suitability under U.S. law), (2) the assessments conducted by the advisers fails short of an assessment by a prudent financial advisers, and (3) the investment recommended does not match an investor's needs.

It is unnecessary to evaluate Powell's claim here since it is beyond the scope of this thesis. The framework used by Powell is based on the influence of the regulatory regime on the standards of conduct, which permits investors to sue on the basis of acting below the standards of the industry as represented in COBS. This framework for enforcing regulatory rules is better suited to examining the influence of the regulatory regime on private law principles or, *vice versa*, the role of traditional private law action in enforcing regulatory rules. In either case, these frameworks are unhelpful in the present study. Firstly, the nature of the inquiry is different. The main inquiry of this section is to determine how private enforcement of the regulatory rules has been effective, as provided by the regulatory regime. In doing so, Part II demonstrates that the instrument for the private enforcement of the regulatory rules is

⁶²² Jackson and Powell (n 579) para 15-014

⁶²³ Ibid

s.150. Secondly, there is no direct indication within the regulatory regime that regulatory rules are meant to be privately enforced through normal private actions subsequent to their influence on the standards in any given industry.⁶²⁴ Finally, supposing that it is mistaken to exclude Powell's claim from this section, on the face of his claim is that the investor might be better served to sue for a breach of suitability on the basis of a private cause of action on misrepresentation rather than s.150, would directly suggest the ineffectiveness of s.150 as an instrument to privately enforce the regulatory duty of suitability.

Suitability as upheld by the FOS is also excluded from the discussion, but for different reasons. Firstly, the unavailability of detailed accounts of awards makes it difficult to assess how the FOS has developed the requirement of suitability. How they differ would be a matter of speculation since there are no published awards and, thus, it is thought the research is better served by excluding suitability as treated by the FOS. Secondly, this study does not investigate whether or not FOS 'fair' treatment of suitability is different from the approach taken by courts. Nevertheless, this study does pre-suppose the existence of such differences, as a result of the regulatory mandate that the FOS decides complaints according to what is 'fair and reasonable'. So far, English courts have shown little inclination to interfere with the work of the ombudsmen despite their departure from English law principles. It is noted that unless there is gross negligence, an ombudsman has discretion as to how to reach its conclusion. Some examples of gross negligence have been identified by courts,

⁶²⁴ There was an argument that the rule-making power of the authority of in the FS regime would permit the modification of common law duties; however, there was no claim that the regulatory rules dealing with the conduct of business were meant to be enforced privately by traditional private action; see Jack Beatson, 'The Regulations Governing The Financial Services Industry and Fiduciary Duties Under the General Law' in Ewan McKendrick (ed.), *Commercial Aspects of Trusts and Fiduciary Obligations* (n 633)

including exceeding the cap limit for awards;⁶²⁵ misapplying a code of conduct rule;⁶²⁶ an error of material fact,⁶²⁷ or where the ombudsman was irrational on the basis upon which they departed from legal rules.⁶²⁸ Moreover, it is recognised that an ombudsman has the right to make his judgement on the basis of the principles for business in awarding compensation for eligible complainants, even though the FSA expressly indicates that the Principles are not actionable.⁶²⁹ Accordingly, given the limited grounds for interference by courts, it is reasonable to expect that the FOS could reach different conclusions from courts.

If the FOS is able to reach different conclusions and since there is no empirical research that compares suitability standards as used in the courts with their use by the FOS, it is reasonable to claim that they may differ in their conceptualisation and application of suitability and avoid including them in the analysis in the present study. Interesting future research might compare treatment of suitability by the FOS and courts. It would also be interesting to examine how the impact of suitability through the regulatory regime enhances other private causes of action as suggested by Powell. These are some of the issues that this section has uncovered which would be suitable for future investigations.

To sum up, this section attempts to evaluate suitability according to the instrument provided by the FSMA in deploying the concept of private enforcement of

⁶²⁵ *Bunney v Burns Anderson Plc* [2007] EWHC 1240 (Ch)

⁶²⁶ *R (on the application of Norwich and Peterborough Building Society) v Financial Ombudsman Service Limited* (2002) EWHC 2379 (Admin), paras 69, 71

⁶²⁷ Examples are ignoring established fact or the ombudsmen took into account irrelevant facts; *R (on the application of Green trading as Green Denman & Co) v Financial Ombudsman Service Limited* [2003] EWHC 338 QBD (Admin), para 60

⁶²⁸ *R. (on the application of IFG Financial Services Ltd) v Financial Ombudsman Service Ltd* [2005] EWHC 1153 (Admin)

⁶²⁹ 'The high level of generality in the expression of the Principles is not of itself the reason for their exclusion under s150(2). After all, they are no more in some instances than broad expressions of common law concepts, which do suffice for actionability ... [b]ut even if that were the reason for their exclusion, that could not assist in showing that they were incapable of giving rise to redress on a fair and reasonable basis' in *R (on the application of the British Bankers Association) v Financial Services Authority* [2011] EWHC 999 (Admin), para 86

the regulatory rules, namely s.150 as illustrated in Part II. This section demonstrates that the regulatory framework has not provided additional protection to enhance private enforcement; COBS does not introduce a novel duty, since the concept of suitability had been already recognised under private law, neither does it provide a detailed picture that facilitates a s.150 action in comparison to normal tort action. For these reasons, it is argued that the private enforcement of suitability as discerned by the regulatory regime is ineffective. Problems with lack of clarity as to when a personal recommendation is provided, the scope of the duty of advisers and the absence of a means to assess how to fulfill suitability are suggested areas that lack details.

Part IV Conclusion

This chapter attempts to evaluate whether the current regulatory framework ensures that both suitability and best execution have been implemented in a way that permits retail investors to enforce them directly. In doing so, this chapter considers the instrument used by the framework to provide private enforcement. That was attempted by, firstly, analysing the regulatory regimes established with special reference to its backgrounds; and, secondly, investigating thoroughly how the UK has implemented the regulatory requirements.

In part II, it is noted that both suitability and best execution are imposed upon service providers by the FSA through its rule-making power exemplified in the COBS. That being the case, the regulatory rules provided in the COBS are supplied with private enforcement through s.150 of FSMA, which provides for a cause of action in form of tort for a 'breach of statutory duty'. It is noted that s.150 is not novel in financial law in the UK and was carried forward from the previous regulatory regime, the FS. However, scholars have identified some issues that are related to the

effectiveness of tort for a breach of statutory duty for private enforcement. In particular, the restriction of private causes of action to private persons is claimed to be the principal reason for the ineffectiveness. The restriction claimed to provide for a cause of action to those with few means or resources to actually exercise their rights. Part II concurs and, furthermore, advances the criticism that the role of the regulator itself, through the categorisation of clients and the association of the actionability with specific categories, may also provide additional restrictions upon those who could sue. In short, if s.62A is criticised for its narrow scope, s.150 is even narrower as most of the regulatory rules focus on retail clients given that it is an unnecessary condition for private persons, entitled to action under s.150, to be a retail client.

It could be expected that, regardless of the critiques, s.150 could have been effective at least for retail clients who are subject to the main protection in the COBS. Consequently, the two benefits associated with the tort of breach of statutory duty were analysed for each of the two regulatory requirements in terms of whether or not a new duty was introduced or a more detailed account of what constitutes the fulfilment of the requirements was provided.

In light of the discussion of suitability, it is pointed out that the concept of the suitability of financial advice was recognised before the introduction of suitability in the FS regime. Reference to cases before the FS regime was essential to counter any criticism that suitability spilled over from the regulatory regime to private law through representation of the standards of the industry. Moreover, while acknowledging the impact of the MiFID, it is argued that the COBS does not provide enough detail in significant areas to allow for private enforcement. Firstly, the COBS is unclear about when the substantive suitability requirement has to be complied with. The notion of ‘personal recommendation’ in the COBS makes it difficult for service

providers to determine whether or not there is a need to comply with suitability. As much as it is difficult for service providers, the wider approach adopted creates difficulties for private enforcement in terms of whether or not the advice supplied is subject to suitability. The ambiguity of the treatment of financial advice may spill over to other areas of private enforcement as a breach of the General Prohibition, where it is possible that consumers may face the burden of convincing the court that a financial advice has been provided. Furthermore, this approach requires an investigation by the courts into what was said at the time of advice. Thus, retail investors need to recollect conversations and what was said long ago in order to satisfy the court that there was an advice amounting to personal recommendation. Secondly, since suitability is provided through tort law, the COBS does not clarify the scope of the duty imposed on advisers. It is difficult to accept that the duty of a salesperson at a bank branch would be similar that of a full and independent financial adviser. Such a clarification would benefit private enforcement by reducing the level of uncertainty associated with determining whether or not the advice provided matched the standards within a specific class of advisers. Finally, the COBS does not detail how to assess or to gauge how suitability has been provided and fulfilled. While this might be a problem for compliance departments at service providers, it is a real burden on retail investors who need initially to make sure that the advice was unsuitable, and then to satisfy the court that such would be the common view within the industry.

These points support the view that suitability does not supply the benefit sought from the regulatory regime through a tort of breach of statutory duty, and therefore concludes that suitability as implemented by the FSMA regulatory framework is ineffective in enhancing private enforcement.

In contrast to suitability, which provides neither a novel duty nor clarity, the best execution rule is clear and detailed. Such clarity and detail could have led to the conclusion that the FSMA regulatory framework has been effective. However, that is not the case. Reference to the history of best execution suggests that it was developed due to regulatory oversight and litigation through the class-action system rather than actions by individual investors. This is explained by the minimal damages that retail investors would receive in cases of breaches of the best execution requirement. Accordingly, in evaluating the FSMA regulatory regime, it is argued that there is no incentive for the private enforcement of best execution by retail investors. Consequently, it is claimed that best execution is ineffective, not because of the absence of the expected benefit of the instrument of implementation under s.150 as much as the lack of incentive to enforce the standard in practice.

One question that may arise concerns the reason for evaluating suitability in reference to the benefits sought after from a regulatory regime in a tort for a breach of statutory duty, whereas with best execution a historical examination was referred to reveal to claim its ineffectiveness. The answer to this question concerns the nature of the main research question of this study, which asks: 'is the FSMA regulatory regime effective in providing a framework for private enforcement of the behavioural standards to retail investors'. The study supposed that the FSMA regulatory regime is effective and hence conducted an investigation to identify evidence to negate the statement. Accordingly, it was sufficient in case of suitability to demonstrate the ambiguity of the rule itself in COBS, whereas with best execution there was a need for certainty before claiming the effectiveness of the framework since the absence of evidence is not evidence of absence. Therefore, the historical analysis helped to

identify the context that facilitated the application of best execution, which then was reflected back to the UK context.

Also, the historical analysis of the two regulatory requirements illustrates the policies behind them both being developed by courts in response to the malpractice of professionals. The mis-selling of securities by brokers to investors that do not match their needs or investment objectives required recognition of suitability to ensure the link between the products sold and the investor's needs. Best execution was also developed in response to the malpractice of brokers profiting from buying cheap and selling high to their customers. In both rules, the issue of information asymmetry, as explained in detail in previous chapters, was present. In the case of selling shares, brokers exploited the information asymmetry of investors in relation to the risk associated with the securities sold. In contrast, in the case of executing orders, brokers took advantages of their knowledge about where to buy cheap in markets with multiple stock exchanges to profit at the expense of their customer.

Accordingly, the policies underlying suitability and best execution are suggested to be vital in maintaining investor's confidence that there will not be malpractice by professionals.

But maintaining investor confidence through the regulatory requirements of suitability and best execution cannot be achieved without an enhancement of the role of private enforcement. The use of public enforcement is complementary rather than a substitute, as noted in previous chapters. To put this in perspective, comparative research in the field of enforcement by regulators of financial services illustrate that the FSA is not as strong as it should be in comparison to other enforcement agencies in other common law legal systems.⁶³⁰ Consequently, it could be argued that the

⁶³⁰ Jackson (n 55); Coffee (n 56); Jackson and Roe (n 56)

private enforcement is vital in the UK to compensate for weak public enforcement by the FSA.

The issue with the reliance on FOS to enforce suitability and best execution for retail clients is that it leaves some cases of retail investors above the cap limit outside the scope of its service, and therefore unable to access its service. Also, relying on the FOS does not help in developing the concept of suitability and best execution due to the lack of involvement by courts and their educative value of developing a public corpus of jurisprudence as well as providing normative rules to govern future transactions.

This part has prompted many questions worth investigation by future research. Powell argues that the importance of suitability lies in the misrepresentation private action provided by English law; and this is an area where there is a gap in the literature concerning the UK in comparison to the US. Thus, an objective analysis is required to examine the impact of suitability not only with regards to misrepresentation, but also other private causes of action such as the tort of negligence. Moreover, research could fruitfully examine the different kinds of private enforcement of securities regulations, such as the regulatory requirement to provide risk warning. More immediately practical would be a research able to suggest appropriate responses to financial advice received via the Internet; including how and when financial advice should be subject to suitability.

Chapter Four

Saudi Arabia

The previous chapter has examined how, as regulatory requirements, both suitability and best execution have been supported by regulatory private enforcement in the UK. It was shown that measures were introduced through the COBS rulebook and private enforcement was provided for through s.150 of the FSMA. It is argued, then, that the way that the FSMA framework works does not effectively permit retail investors to privately enforce the two regulatory requirements.

This chapter seeks to evaluate the implementation of these two regulatory requirements in Saudi Arabia by attempting to answer four questions. The first concerns what suitability and best execution entail, as implemented in Saudi Arabia. Secondly, what are the policies behind Saudi secondary capital market regulation in general and these regulatory requirements in particular? Thirdly, what are the difficulties, if any, in the existing law that hinder private enforcement by retail investors; and finally, what recommendations could analysis suggest to enhance the private enforcement of the two regulatory requirements?.

As with the UK, this chapter is divided into four parts. Part I provides a brief background of the current regulatory regime for securities markets in Saudi Arabia. Part II examines the current regulatory framework focusing on the techniques used in implementing suitability and best execution to permit retail investors to pursue a civil action. Part III evaluates both suitability and best execution in their context, giving

definition, criteria and guidance. Finally, part IV includes a discussion and conclusions.

Part I Background

The modern legal system of Saudi, as opposed to Sharia, law is the main topic for discussion in the following parts. It is impossible, however, to discuss any legal or regulatory issue concerning Saudi Arabia without reference to the principles and rules of Islam or Shari'a. It is pointed out below that Islamic jurisprudence as strictly applied by the prevailing school of thoughts in Saudi Arabia makes it difficult to accommodate different aspects of legal modernisation needed to meet economic and social needs of the country. It is, furthermore, argued that these difficulties are not only confined to conventional banking transactions which include the application of interest, or usury, which are clearly prohibited by Islam, but also other areas of modern commercial transactions such as the recognition of corporations as legal entities separate from shareholders. While it would be interesting to pursue an inquiry as to compatibility between Shari's as applied in Saudi Arabia and current modern business practices, this must be left for future research.

This study seeks to analyse the practice of the regulator in Saudi Arabia in implementing international standards for regulation of securities markets, namely those pertaining to suitability and best execution. Consequently, this part is organised into four sections. The first briefly demonstrates both the importance and legitimacy of Shari'a within the legal context of Saudi Arabia. The second section lists some difficulties facing policy makers in modernising the Saudi economy, and the third provides a historical background of the legal framework for securities markets in

Saudi Arabia. The final section summarises the discussion conducted so far and supplies some concluding remarks.

A) The Shari'a as a legal source in Saudi Arabia

In principle, it is reasonable to maintain that the fundamental source of law in Saudi Arabia is Islamic Law (the Sharia) which consists of the Holy Qura'an and the teachings of the Prophet Muhammad (the Sunnah) as their primary sources.⁶³¹ Consequently, this section aims to highlight some difficulties associated with the reliance of Shari'a as fundamental source of law.

To start with, the primary sources, the Holy Qura'an and the Sunnah, address certain issues in general terms and are sometimes worded in a way that allows different interpretations. That being the case, developments in Islamic law have relied heavily on *Ijtihad*, or personal reasoning, which depends on the intellectual abilities of the relevant scholar.⁶³² Having said that, the deductive processes used with the primary sources have been limited to four main Schools of Thought within *Sunni* Muslims: the *Hanafi*, the *Mailiki*, the *Shafai'I* and the *Hanbali*.⁶³³

However, notwithstanding the existence of the four Schools of Thought, it has been argued that the most significant issue is that due to its extreme complexity Sharia creates difficulties when applied in modern society.⁶³⁴ From a postcolonialism perspective, there are two explanations for this complexity and indeterminacy. Firstly, it arises from the lack of detailed guidance in the primary sources of Shari'a governing both commercial and civil transactions. For example, the Holy Qura'an provides only 80 verses concerned with strictly legal concepts out of over 6000

⁶³¹ Mohammed Al-Qahtany, 'Doing Business in Saudi Arabia: Implication for International Investors, (2003) 8 Journal of Transnational Management Development 3

⁶³² For a detailed analysis of *ijtihad* and its n current application in Saudi Arabia, see Frank Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000)

⁶³³ *Ibid*

⁶³⁴ William Ballantyne, *Essays and Addresses on Arab Laws* (Curzon 2000) 84

verses.⁶³⁵ For this reasons, Islamic jurisprudence relies heavily on personal reasoning and deduction and the work of scholarship for it to develop in line with the needs of society. The problem with this approach, however, is that societies prioritise their needs and perceive justice differently and thus different scholarly opinions are available for the same issue.

Secondly, the deductive processes using with the main sources the four schools were established in the Middle Ages to deal with legal issues on a case by case basis and with a series of nominate contracts instead of providing general principles.⁶³⁶ As a result, within a Shari'a system it is difficult to determine what the law entails for an economic transaction before a dispute arises which is incompatible with modern economic contexts which require both certainty and clarity of law to allow economic agents to transact and develop novel economic activities and contracts. For instance, in the famous arbitration awards, *Saudi Arabia v Arabian American Oil Company (Aramco)*,⁶³⁷ the arbitrators agreed that the *Hanbali* school of Islamic law, which was the basis of law in Saudi Arabia, was the applicable law for the disputed agreement. They had, however, to reject the application of *Hanbali* school and Islamic law and instead referred to world-wide practice for the kind of activity that the agreement governed on the grounds that Islamic law as a system developed before the demands of modern technologies, finance and marketing provided by modern international corporations arose.⁶³⁸ This study does not evaluate whether such claims are right or wrong since, this is not within the scope of the research,⁶³⁹ but brings attention to the problem identified by Ballantyne that a tribunal

⁶³⁵ Ibid, 35

⁶³⁶ Ibid, 87

⁶³⁷ (1963) 27 ILR 1 17

⁶³⁸ But see criticism for the rejection of the law of Saudi Arabia in Abdulrahman Baamir, *Shari'a Law in Commercial and Banking Arbitration: Law and Practice in Saudi Arabia* (Ashgate 2010) 97-107

⁶³⁹ For such criticism see Baamir, Ibid

or a court within a geopolitical system that applies Shari'a does not enjoy the freedom of international arbitration tribunals to reject Islamic law and refer to modern practices.⁶⁴⁰ A national court or a tribunal subject to Shari'a must apply it to the dispute before it.

However, the difficulty facing any national court or tribunal is emphasised by Al-Sanhouri, a great authority in the Arab legal scholars, when he attempted to extract a theory of contractual liability in Shari'a:

'It cannot be said there is a theory of contractual liability in the Islamic jurisprudence akin to that which we have seen in Western jurisprudence. It is only possible to extract from the provisions laid down by Islamic jurisprudence the counterpart of the theory of contractual liability in Western jurisprudence.'⁶⁴¹

It could be thus suggested that, in dealing with current problems, Al-Sanhouri supports the idea of relying on Western jurisprudence and examines problems in terms of their equivalents in Islamic jurisprudence, rather than making deduction based on scholars from different schools. While many comparative writers indeed have adopted such an approach,⁶⁴² it is still possible to assert the absence of general principles for transactions, contracts and obligations under Shari'a still exists.

Further legal issues arise where the needs of a society for moderation are in conflict with Shari'a, particularly where states' interests contradict with Shari'a principles. Such a state of affairs were not dealt with in pre twentieth century Islamic scholars because the concept of a state as an economic, social and political entity is a

⁶⁴⁰ Ballantyne (n 632) 86

⁶⁴¹ Abduleazzag Al-Sanhouri A, 'Masader Al-Haq Fi Al-Figh Al-Islami' cited in Ballantyne, *ibid*, 86

⁶⁴² See for example Nicholas Foster, 'Owing and Owning in Islamic and Western Law' ch. in Eugene Cotran and Martin Lau(eds), *Yearbook of Islamic and Middle Eastern Law, Volume 10 (2003-2004)* (Brill 2006) 68-73

European idea that was transplanted at the beginning of the 20th century to the Arab world in particular. Previously, the religious and political aspects of the state are united in Islamic legal theory and thus the head of state, namely the *caliph*, was the head of both political and religious institutions.⁶⁴³ It is inconceivable, therefore, that there would be a conflict between religious institutions on the one hand and the state on the other as was characteristic of relations between the Pope and heads of state in Europe in past centuries.⁶⁴⁴

The development of state as a source of legitimacy has not hindered the legitimacy of Shari'a; it is highly regarded among Muslims as a divine law or the sacred code and the source of legitimacy. From a Western perspective, this position of Shari'a is known as 'divine nomocracy' which evolved between the church heads of states in Europe.⁶⁴⁵ Nomocracy, which is a system of government 'based on a legal code; the rule of law in a community',⁶⁴⁶ exists where 'a supreme law regarded as of divine or natural origin is the source of governing authority'.⁶⁴⁷

The previous account fails to provide a theoretical resolution of or conceptual justification for conflicts occurring between the need for modernisation and Shari'a, or in other words, where state interests conflict with Shari'a principles. Evidently, such an issue does arise when one Muslim state starts using the law as an instrument to achieve social or economic objectives which diverge from Islamic principles. Islamic jurisprudence has developed various justifications that permit overcoming some Shari'a principles on the grounds such as public interest (*Masslaha A'ammah*), or extreme necessity (*Al-Darrorat Tobeeh Al-Mahthorat*). However, where there is direct conflict with clear principles of Islam, such as with usury or *ribba*, it is very

⁶⁴³ Ibid

⁶⁴⁴ Ibid

⁶⁴⁵ Muhammad Hamidullah, *Islamic World: Inter-State Relations* (Anmol 2001) 3-5

⁶⁴⁶ Oxford Dictionary, cited in Hamidullah, *ibid*

⁶⁴⁷ Hamidullah (n 643)

difficult to maintain such justifications for society at large. In this respect, it is noted that Shari'a as a religious law 'is not intended to develop according to the dictates or needs of society; quite to the contrary, society and its circumstances ... [are] supposed to evolve according to the dictates of the Shari'a'.⁶⁴⁸

Saudi Arabia provides a living case through which to explore these theoretical issues. It is reasonable to expect high priority to be given to Shari'a and Islam within a society that proclaims itself to be a one-hundred per cent Muslim. However, the experience of Saudi Arabia with financial markets in general and securities markets in particular is proof of claims about the ambiguity and absence of both theoretical and conceptual frameworks within Islamic jurisprudence for conflicts between modernisation, modern states and Shari'a. This has resulted in uncertainty, vagueness and the division of substantive law within modern Saudi legal history, which is the subject of discussion in the next section.

B) Saudi Modern Legal History

The influence of Shari'a in Saudi Arabia can be traced back to the time of the establishment of the state itself as a geopolitical entity in 1932 by King Abdulaziz bin Abdularhaman Bin Saud. Several legal reforms have since been introduced up to the present but, nonetheless, the Shari'a has been always the paramount source of law.⁶⁴⁹

Currently, Islam and Shari'a are the primary sources of law within the Saudi legal context. The Basic Law of Governance, which was introduced as an application of the concept of constitution in 1992,⁶⁵⁰ Article 1, clearly states that:

⁶⁴⁸ Ballantyne (n 632) 29

⁶⁴⁹ For detailed analysis and discussion, see Vogel (n 630)

⁶⁵⁰ Royal Decree No: A/90, 27-08-1412 (01 March 1992) on the Basic Law of Governance. The Basic Law consists of 83 Articles and nine parts. A full and translated version of the Basic Law is available at <http://www.saudiembassy.net/about/country-information/laws/The_Basic_Law_Of_Governance.aspx> accessed 29 June 2011

‘The Kingdom of Saudi Arabia is a sovereign Arab Islamic state with Islam as its religion; God's Book and the Sunnah of His Prophet, God's prayers and peace be upon him, are its constitution, Arabic is its language’

Throughout the Basic Law, there are many references to Shari’a and its two major sources, the Qura’an and Sunnah.⁶⁵¹ More importantly, the Basic Law states that the law applicable to disputes in Saudi Arabia is the Shari’a. Article 48 states that:

‘The courts will apply the rules of the Islamic Shari'ah in the cases that are brought before them, in accordance with what is indicated in the Book and the Sunnah, and statutes decreed by the Ruler which do not contradict the Book or the Sunnah’.

Interestingly, nothing in the Basic Law refers to legislation and legislative powers as source of law, or *Tashree’a* or *Tanithimat* as known in Saudi Arabia. The Basic Law provides for separation of powers within the state, it refers to three recognised kinds of authorities; judicial, executive and regulatory.⁶⁵² The three authorities would ‘cooperate with each other in the performance of their duties, in accordance with this and other laws’, with the understanding that ‘The King shall be the point of reference for all these authorities’. Consequently, it could be suggested that the Saudi legal system recognises three kinds of authority, but meanwhile identifies the King as the source of all authority.

⁶⁵¹ See for example Articles 5-8, 17, 21, 23, 26, 38, 45, 48, 57, 67

⁶⁵² Article 44

That being the case, it should be noted that it is a mistake to assume that the regulatory power ascribed to the King in the Basic Law is similar to legislative powers associated with elected assemblies in democratic states. Reference in the Basic Law to the regulatory authority may suggest the recognition of such authority but using different words.⁶⁵³ As far as the regulatory authority is concerned, the Basic Law states that the regulatory authority's duty

'lays down regulations and motions to meet the interests of the state or remove what is bad in its affairs, in accordance with the Islamic Shari'ah. This [regulatory] authority exercises its functions in accordance with this law and the laws pertaining to the Council of Ministers and the Consultative Council'.⁶⁵⁴

Thus, it is reasonable to state that a regulatory authority's function is to meet the interests of the state and to exercise its function as subordinated to other institutions. But there is no role for the regulatory authority to define and specify the interest of the state ascribed to the legislators in democratic systems. Accordingly, it could be argued that the regulatory authority provided in the Basic Law is different from the legislative power provided in other countries constitutions. Accordingly, it could be claimed that a regulatory authority does not have legitimacy to shape the law or the interest of the state in the way that other regulators in western countries do unless the regulatory actions conform with Sharia.

Moreover, it is difficult to identify the real powers of the regulatory authority or to provide examples of it since the Basic Law does not elaborate. The Basic Law

⁶⁵³ For example, it is suggested that the term regulator is adopted instead of legislator in Saudi Arabia because the latter can be only used to refer to God, the only legislator; see for example Jan Otto, *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in the Past and Present* (Leiden University Press 2010) 146

⁶⁵⁴ Article 67

mentions the 'regulatory authority' twice as stated above, and consequently it is reasonable to suggest this regulatory power is akin to the concept of regulation rather than legislation.

According to the previous discussion, two points could be emphasised. Firstly, Shari'a is the main source of law and obligations in Saudi Arabia. Consequently, it could be suggested that a breach of Shari'a in any law, regulation or action could be claimed to be unconstitutional, at least in theory. Secondly, while the Basic Law identifies three kinds of authority, there is no legislative authority as such perceived in democratic countries. However, such authority as institutionalized by the Basic Law is more akin to a regulatory regime rather than legislative power. Consequently, it could be argued that there is no recognition of legislative powers within the Saudi legal context that could have provided justifications for overcoming Shari'a and positive law.

These two factors, the emphasis on Shari'a and the absence of legislative power, reinforce the domination of Shari'a while they do not help to overcome the problems associated with the Shari'a as identified in the first section. In contrast with other Islamic countries where their constitutions state that Shar'a is a source in Saudi Arabia, it is considered the main source. Thus, it could be suggested that Saudi Arabia confines itself to Shari'a and its rules as the essence of the legal system. Such an approach may have two practical difficulties. Firstly, it does not clearly overcome the issue of the complexity of the application of Shari's as a result of its lack of general principles.

Secondly, the Basic Law does not clearly consider the incompatibility between Shari'a and its principles that prohibit interests or usury and various financial

practices, such as banking, that are the core of modern economies.⁶⁵⁵ The lack of any source of legitimacy for public interests that contradict with Shari'a in contradiction with general legal notion as the rule of law and the certainty of legal rules. While such issue has existed in the past, it could be argued that it will still persist. Thus, it is necessary to evaluate how policymakers attempted to overcome the issue. Accordingly, the approach of policy makers in dealing legitimacy questions is demonstrated by the development of securities markets law, which is discussed in the next section.

C) The History of Modern Legal System for Securities Markets

It is reasonable to claim there has been an uneasy relationship between the needs for modernisation on one hand, and Shari'a as applied in Saudi Arabia on the other hand. This has been observed ever since the establishment of the country in 1932. The fractious relationship has not been confined to known major areas of conflict, such as with usury (*riba*) and excessive risk taking (*garar*), but it is also observed in other Western legal developments which were unfamiliar to Shari'a, such as corporations. For more discussion reference can be made to the literature dealing with Saudi Arabia, but nonetheless a snapshot of the historical background is essential to, firstly, identify the approach to reforms used in Saudi Arabia with financial markets, and secondly, understand the shape of the current position.

Given the direct clash between banking services and Shari'a principles; namely in relation to interest (usury), it is reasonable to expect that the government would have dealt with the issue as soon as banking services were introduced into the Kingdom. However, although banks and banking services have been available since

⁶⁵⁵ As phrased by Ballantyne, the problem is between 'an irresistible forces against an irremovable object', Ballantyne (n 632) 26

1932,⁶⁵⁶ it was thought that there was no need for legal intervention to isolate banking services from the jurisdiction of Shari'a courts until the 1980s before which time the government had neglected to deal with the issue of banking services, as discussed below.

It could be suggested that the first urgently needed for legal reform as a result of conflicts between substantive financial law and Shari'a was in the 1960s. The first need for regulatory intervention because of the incompatibility of Shari'a as applied in Saudi Arabia and modern practice of commerce appeared when the Commercial Paper Regulation was enacted.⁶⁵⁷ This regulation incorporated the Geneva Uniform Law of Bill of Exchange (1930) and of Checks (1931), which included provisions related to modern commercial practices, including interest in negotiable instruments. When the Saudi legislative authority came across a provision in the Geneva law dealing with interest, they stated that a term in a promissory note pertaining to a payment of interest should be treated as if it were not there.⁶⁵⁸

The real difficulty here was that the Saudi legislative authority could not overcome or simply consider as non-existent provisions that provided for statutory limitations on the validity of bills of exchanges (three years) and of cheques (six months). The requirement of a time limitation was in direct conflict with Shari'a as applied in Saudi Arabia where acquired rights are not forfeited by the lapse of time.⁶⁵⁹ To get around this, the Saudi text provided different terminology to the same effect, by attaching the phrase 'a cause of action will not be entertained by the courts',

⁶⁵⁶ For example, the first bank in Saudi Arabia was established in 1926 and was called 'The Netherlands Trading Society', currently named the Saudi Hollandi Bank, see <http://www.shb.com.sa/vEnglish/showpage.asp?objectID={7216489E-FA3E-4EA5-A4B8-99CEE053E3AA}> accessed 29 June 2011

⁶⁵⁷ The Law of Commercial Papers, *Nitham Alawraq Altejariyah*. Issued by Royal Decree No. 37 dated 11/10/1383 H. (1963)

⁶⁵⁸ Article 6

⁶⁵⁹ See George Sfeir, 'The Saudi Approach to Law Reform' (1988) 36 Am.J.Comp.L. 729, 735

whenever limitations of time appeared in the Geneva Law.⁶⁶⁰ This approach, nevertheless, did not solve the issue at hand since Shari'a courts, which were the general court, could entertain such a claim after the lapse of prescribed time if the cause of action could be made on a non-regulatory basis.⁶⁶¹ Therefore, a special tribunal with jurisdiction over disputes relating to negotiable instruments was created, known as the Committee for the Settlement of Negotiable Instruments Disputes (CSNID).⁶⁶²

In contrast to negotiable instruments, which Saudi policymakers dealt with from the start, they neglected the need to deal directly with the issue of banking services even though they involved usury which is prohibited by Islam.⁶⁶³ There are many instances where the government attempted not to confront the issue; a clear example of this 'wilful neglect' approach could be identified in the Saudi Arabian Monetary Agency (SAMA), which is the country's central bank. SAMA's establishment charter prohibits it from operating in violation of Shari'a, but meanwhile provides that its main responsibilities include the regulation of commercial banking and the stabilization of the country's currency (the Riyal).⁶⁶⁴ Without going into detail, both responsibilities require the involvement of SAMA in some interest-related activities prohibited under Islam and Shari'a.⁶⁶⁵

⁶⁶⁰ For instance in articles 84 and 116

⁶⁶¹ Sfeir (n 657)

⁶⁶² Note that this committee still exists in Saudi Arabia.

⁶⁶³ The underlying concept was clearly put that 'while it is legitimate to earn profits from earning money, money should not simply breed money', Sfeir (n 657) 738

⁶⁶⁴ 'The Agency shall not charge any profits on its receipt and payments and shall not act in any manner which conflicts with the teaching of the Islamic law. The agency shall not undertake any of the following functions:

(a) paying or receiving interest...', Article 3 of the Charter of The Saudi Arabia Monetary Agency, Royal Decree No.23 1377/2957. The Charter is available on the internet at <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>> (visited 07.03.2011)

⁶⁶⁵ For example, as the central bank, SAMA needs to pay interest on funds deposited by local banks. Furthermore, the stabilisation of the country's currency requires buying and selling certain derivatives contracts that involve the payment of interests. For discussion about the role of SAMA see J. O. Ronall, 'Banking Regulation in Saudi Arabia' (1967) 21 Middle E.J. 399

An even clearer example of the approach of policymakers in Saudi Arabia as to avoid dealing with the problems of banking and Shari'a can be found in the Banking Control Law introduced in 1966.⁶⁶⁶ There is nothing in the law that refers to, or deals with, the subject of usury or interest.⁶⁶⁷ As strange as it sounds from a legal perspective, both Saudi and foreign banks had been conducting business in the conventional manner despite the threat of the unenforceability of interest payments under the Shari'a. But this unwritten rule, that banks paid and earned interest, was challenged when economic conditions deteriorated so badly that some borrowers tried to escape their obligations to the banks by invoking the Shari'a prohibition against usury in the 1980s.⁶⁶⁸ In response to this threat to banks, the Saudi Minister of Commerce entrusted his ministry's legal committee with the settlement of disputes between banks and their customers 'arising from the contracts and banking transactions'.⁶⁶⁹ This temporary solution of dealing with disputes through a legal committee turned into a permanent solution upon the establishment of a new committee under SAMA called the Committee for the Settlement of Banking Disputes (henceforth CSBD).⁶⁷⁰ The CSBD was given jurisdiction over the settling of disputes between banks and their clients arising from contracts and transactions, except those concerning commercial papers such as bills of exchange which should be settled through CSNID. CSBD was in fact given powers similar to the courts; for example, it

⁶⁶⁶ Royal Decree No.M/5 of 1368/1966

⁶⁶⁷ The law is available on the internet at <<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>> accessed 29 June 2011

⁶⁶⁸ Sfeir (n 657)

⁶⁶⁹ Those contracts concluded after 25 December 1985, see decision no 822 of 13/04/1406 (26 December 1985)

⁶⁷⁰ The regulation of the Committee for the Settlement of Banking Disputes, issued by Royal Decree No. 8/729 of 10/07/1407

might decide to freeze a party's assets or restrict parties from travelling outside of Saudi Arabia.⁶⁷¹

This study has attempted in the previous paragraphs to draw attention to these issues associated with the prevailing approach in Saudi Arabia to avoid the incompatibility of modern economy and Shari'a but not to critically examine it. There are three insights that could be emphasised in this section. Firstly, the *ad hoc* approach of Saudi legislative authority in dealing with legal-economic issues that conflict with Shari'a is by entrusting the jurisdiction of these disputes to special tribunals. However, it is not maintained that there is a problem with the restriction of jurisdiction to special tribunals *per se*. Rather, it is maintained that, by relying on this approach to avoid dealing with many issues including legitimacy, it is unlikely that the rule of law or legal certainty needed in any country for economic development will be enhanced or achieved.

Secondly, the *ad hoc* approach may raise other questions as to the forms rather than the substance of law. For example, the historical background of the approach in response to banking disputes may be questionable in the way that it was executed. It is unacceptable from the rule of law perspective that a member of the executive power, namely a minister, has the authority to change the jurisdiction of particular disputes, such as those concerning banking and interest, all of a sudden to a committee that has no judicial legitimacy even from the King himself. It is possible to argue that there was a need for a quick response to calm the banks or otherwise severe economic disruption could have happened given that the CSBD was legitimately established a year later. However, such an answer may not be satisfactory for those in favour of the rule of law and market economy systems, especially after the

⁶⁷¹ It is noted that CSBD is 'the only authority in Saudi Arabia that recognises charging interest as a valid practice', see Abdulrahman Baamir, 'Saudi Law and Judicial Practice in Commercial and Banking Arbitration' (PhD Thesis, Brunel University, 2008) 223

membership of Saudi Arabia to the World Trade Organisation (henceforth WTO), as pointed out below.

Thirdly, the importance of the CSBD for this study is that it came into being at a time when only banks were allowed to provide brokerage services in the country and thus disputes between investors and banks with respect to these services had to be dealt with by the CSBD. As a result of this, the historical development of capital markets and their association with banks is critical for the understanding of the evolution of securities law in Saudi Arabia. The subject of historical development of capital market in Saudi Arabia is dealt with in the next section.

D) The Development of Capital Markets

Within the Saudi context, references to securities markets in general and capital markets in particular are mostly associated with stock markets given the relatively recent development of Islamic bond markets within the current framework. Thus, reference is needed to the history of stock markets themselves in order to understand how law relating to securities markets evolved in Saudi Arabia.

To start with, the history of joint stock companies can be traced back to 1935, when shares in the Arabian Automobile Company (subsequently liquidated), were floated to handle the increasing importance at the time of automobiles.⁶⁷² In 1954 Saudi cement companies went public, followed by the privatisation of three electricity companies. However, it was not until the late 1970s that a Saudi secondary stock market began to emerge as a result of the oil boom in 1973. The stock market was supported by the government steps to improve the role of the private sector in the

⁶⁷² The Saudi Stock Exchange (Tadawul), available on its website at <http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMLj2AXA0_vOGNzY18Q1wAoH4kk7x4QZmrgaeITbBOc4GVs4GIEQHdwYpG-n0d-bqp-QW5EOQAsB49z/dl2/d1/L0IHSkovd0RNQUprQUVnQSEhL1ICWncvZW4!> accessed 29 June 2011

economy by participating in forming various joint stock companies through investment agencies.⁶⁷³ Another factor that supported the emergence of stock markets was the government's decision to part-nationalise foreign banks, whereupon banks had to be 60% owned by the Saudi public and 40% retained by foreign shareholders. At this time a number of brokers started to buy and sell shares for themselves and for their Saudi clients; which represented the beginning of brokerage business.⁶⁷⁴

The high revenues from higher oil prices helped the government to initiate major infrastructure projects and modernise the economy between the 1970s and early 1980s, which resulted in increases in both the volume of trading and market capitalisation in response to increased spending by the government.⁶⁷⁵ In the mid 1980s, the government decided to place all stock trading under the supervision and control of SAMA and, therefore, discontinued the existing broker-based stock trading system.⁶⁷⁶

It has been claimed that restricting brokerage to commercial banks was meant to protect the market against the adverse effects of speculation and to help it develop and mature.⁶⁷⁷ But such an account fails to explain why, at that moment, the government decided to do this. A more convincing explanation is that the Saudi government was responding to a stock bubble that had just burst in a neighbouring country - Kuwait, known as *Souk Al-Manakh*,⁶⁷⁸ that had severe effects on the

⁶⁷³ For example the Retirement Pensions Agency and the General Organisation for Social Insurance.

⁶⁷⁴ K.A. Al-Abdulqader, G Hannah and D.M. Power, 'A Test of the Weak form of the Efficient Markets Hypothesis for the Saudi Stock Market' (2007) 6 *Journal of Emerging Market Finance* 167

⁶⁷⁵ Ibid

⁶⁷⁶ Tadawul (n 670)

⁶⁷⁷ Alajlan (n 25)

⁶⁷⁸ The market had developed as a parallel stock exchange dealing in the shares of Gulf companies not resident in Kuwait and fuelled by manic speculation. It is estimated that the crash cost \$92 billion dollars at the time of the crash. For more details see Fadwa Darwiche and Fida Darwiche, *The Gulf Stock Exchange Crash: The Rise and Fall of the Souq Al-Manakh* (Croom Helm 1986); Pete Moor, 'Rentier Fiscal Crisis and Regime Stability: Business-State Relations in the Gulf' (2002) 37 *Studies in Comparative International Development* 34

Kuwaiti economy.⁶⁷⁹ From this perspective, it becomes more plausible to suggest that the government's response limiting brokerage services to banks was not *per se* about stock markets development as much as being a case of avoiding what had been witnessed in a neighbouring country. In other words, it was a political rather than economic rationale for intervening and regulating secondary capital markets in Saudi Arabia for the first time.

Similar to the government's *ad hoc* approach described in the previous section, a ministerial committee comprising the Ministers of Finance, Commerce and the Governor of SAMA was formed to supervise activities in the stock markets. In order to fulfil this objective, the ministerial committee issued new rules and regulations in April 1984. These included: (i) the establishment of a share trading system that operated via commercial banks; (ii) the introduction of a supervisory body for all securities trading; and (iii) the opening of a share control department (SCD) under the jurisdiction of SAMA.⁶⁸⁰ Following this, the Securities Supervisory Committee, comprising senior representatives of the two ministries and SAMA, was established to supervise and report directly to the Ministerial Committee. On November 23, 1984, Royal Decree No. 1230/8 was issued to establish the Saudi Share Registration Company (SSRC), which was to be sponsored by local commercial banks under the supervision of SAMA. The SSRC was in charge of managing the records of shareholders and share certificates, as well as providing support facilities for transactions and automatically transferring and registering ownership of transactions.⁶⁸¹

⁶⁷⁹ Rodney Wilson and others, *Economic Development in Saudi Arabia* (RoutledgeCurzon 2004) 69

⁶⁸⁰ Al Abdulqader, Hannah and Power (n 672)

⁶⁸¹ For a detailed historical background on the history of the stock market in Saudi Arabia since 1934 see Sultan Al-Bogami, 'An Examination of the Usefulness of Interim Financial Statements to Investors in the Saudi Stock Market' (PhD Thesis, University of Dundee, 1996)

In parallel to the establishment of SSRC, SAMA established a share trading system that was similar to the systems employed in Germany and Switzerland at that time. Transactions in joint stock companies' shares, however, were to be conducted via Saudi commercial banks alone. While the commercial banks were to act as intermediaries in the transfer of shares on their clients' behalf, they were not permitted to buy or sell shares for their own interest.⁶⁸² With all these foundations for stock markets in place, it could be suggested that this was the beginning of a modern system for share trading. The positive side of SAMA's approach is that it helped to institutionalise the business of brokerage, but at the same time facilitated neither the existence of separate brokerage businesses nor the development of market makers.

The 1990s was the beginning of a new era with the introduction of electronic share trading,⁶⁸³ and the government established an electronic trading system known as the Electronic Security Information System (ESIS). It was hoped that by introducing this system, the fragmented market would be centralised, share price spreads would be narrowed and market liquidity would also improve. The system was successful in achieving those objectives and remained in place until 2001, when a new electronic system called Tadawul, a word that means circulation in Arabic, replaced the ESIS system.⁶⁸⁴ Furthermore, in this new system, the ownership of shares was transferred immediately after the transaction had taken place, which was not possible with ESIS. While both ESIS and Tadawul revolutionised the way the trading of shares was conducted in Saudi Arabia, they neither were recognised formally as stock exchanges in terms of governance of members of the industry in the sense of

⁶⁸² Al Abdulqader, Hannah and Power (n 672)

⁶⁸³ Ibid

⁶⁸⁴ Ibid

other modern markets such as the London Stock Exchange in the UK.⁶⁸⁵ The recognition of the existence of a legal stock exchange was confined later to Tadawul as a result of the introduction of the CML.

It could be suggested that the national capital market before the introduction of CML lack the depth needed in order to develop. The market was not meant to attract foreign investors since participation in capital secondary markets was available only to Saudi national citizens. The only option available to foreigners who wanted to invest in Saudi stock was a single closed-end mutual fund, the Saudi Arabia Investment Fund (SAIF), which was traded in London.⁶⁸⁶ However, in November 1999, the government announced that foreigners, whether resident in Saudi Arabia or not, could invest in the Kingdom's stock market through the purchase and sale of mutual funds that trade in Saudi Arabia. Moreover, before the introduction of the CML, the number of listed companies had increased to 71 companies with a market capitalisation of over US\$ 187million.⁶⁸⁷

This historical account illustrates how policy decisions to monitor stock markets resulted in the restriction of brokerage business to banks. One unintended consequence of confining brokerage services to banks was to bring litigation concerning secondary markets to the CSBD.

The movement of jurisdiction towards the CSBD may have helped in avoiding another legal issue that could have arisen in the Shari'a court. In principle, as far as trading shares in secondary stock markets is concerned, no issue of illegitimacy with Shari'a should be of concerns given the Islamic principle of permissibility (*ibaha*),

⁶⁸⁵ Federal Research Division, *Saudi Arabia A Country Study* (Kessinger Publishing 2004) 210; Wafik Grais and Zeynep Kantur, 'The Changing Financial Landscape: Opportunities and Challenges for the Middle East and North Africa' (World Bank Policy Research Working Paper No. 3050, 2003) 9 <<http://ssrn.com/abstract=636412>> accessed 29 June 2011

⁶⁸⁶ Alajlan (n 25)

⁶⁸⁷ Ibid

(which renders all commercial transactions Shari'a compliant in the absence of a clear prohibition), and it could be argued thus that trading in shares is acceptable, generally speaking.⁶⁸⁸ The problem, however, is that the school of thoughts of Sharia's principles adopted by judges in Saudi Arabia did not recognise separate legal personalities; it recognises the concept of a partnership but not a corporation.⁶⁸⁹ Given that Shari'a courts consider Shari'a in a similar way to the natural law in the Western legal philosophy,⁶⁹⁰ this could be expected to pose dilemmas for policymakers. It is for this reason, among others, that commercial transactions were taken away from the jurisdiction of general courts and included within the jurisdiction of the Board of Grievances.⁶⁹¹ By not permitting Islamic courts to deal with brokerage contracts, a legal problem was avoided. Therefore, it could be argued that limiting brokerage services was beneficial also as a tool to exclude Islamic courts from reviewing these cases.

The discussion in the last two sections suggests that history and religion are two factors which may interact with other factors in producing a unique financial legal system that suits a country at any given time. However, society's needs and circumstances change with time. Economic development and globalisation made it very difficult for the system as it was to be sustained, and thus there was a need for reform. Consequently, the government introduced bold reforms through the CML in 2003. The CML allowed for not only the establishment of brokerage firms and advisory services but also prohibited banks from providing brokerage services. The

⁶⁸⁸ Since the view of the religious institution is the prohibition in trading and investing in companies that are not Shari'a compliance such as banks and insurance companies.

⁶⁸⁹ H Patrick Glen, *Legal Traditions of the World: Sustainable Diversity in Law* (OUP 2007) 184

⁶⁹⁰ This school of thoughts is called *Hanbali*; see Nimrod Hurvitz, 'Schools of Law and Historical Context: Re-Examining the Formation of the Hanbali Madhhab' (2000) 7 *Islam L & Soc* 37

⁶⁹¹ The Board of Grievances is equal to administrative courts under civil law systems which deal with litigation involving the government or governmental agencies. For an excellent reference to the the Board of Grievances in Saudi Arabia see Mohammed Al-Qahtani, 'The Role and Jurisdiction of the Board of Grievances in Saudi Arabia' (PhD thesis, University of Newcastle upon Tyne, 2008); see also Vogel (n 630)

CMA provided also for a separate and distinct judicial committee to deal with claims and litigations brought under the CMA regulatory framework. More details of the CMA are provided in Part II of this chapter, but it is important to understand the reasons behind the introduction of the CML, which is the topic of the next section.

E) The Capital Market Law

In contrast to the UK, where the FSMA was introduced with a focus on the development of financial market regulation, the current regulatory framework in Saudi Arabia was introduced as one instrument among others to reorganise the wider economic and social structure. Thus, it could be suggested that it was more akin to the FS regime. Both social and economic conditions support such a claim. In the mid-1990s these conditions led policymakers to rapidly adopt international financial standards in both trade and finance, resulting in starting the process of becoming a member of the WTO in 1995. Indeed, the case of Saudi Arabia in relation to securities regulation supports the claim that internal geopolitical pressures can be the forces for the development of the regulatory systems in securities markets.

Oil revenues have been the major contributor to the Saudi Arabian economy and budget,⁶⁹² and in the 1990s the prices of oils sank dramatically to almost \$10 per barrel. The government was the major employer in the country, with the private sector playing little part in employment. Due to substantial budget deficits, too little investment in social and economic infrastructure took place and unemployment, thus, was rising.⁶⁹³ The first reaction to the crisis was to increase the pace of the

⁶⁹² Fouad Farsy, *Saudi Arabia* (Kegan Paul 1986); Tim Niblock and Monica Malik, *The Political Economy of Saudi Arabia* (Routledge 2007)

⁶⁹³ Niblock and Malik, *ibid*, 174. This lead low mean level of per capita income for citizens. For a full discussion of the impact of oil revenues, people growth, and policy decisions in Saudi Arabia, see Anthony Cordesman, *Saudi Arabia Enters the Twenty-First Century* (Greenwood 2003); Khaled Al-Sultan, 'Maintenance in Saudi Arabia: Needs and Recommendations for Improvement, (1996) 2 Journal of Quality in Maintenance Engineering 5, 12

privatisation programme that the government had planned but had commenced only slowly.⁶⁹⁴

This decline in economic conditions occurred while considerable growth of the Saudi population was taking place. The UN report on World Population Prospects (2004) estimated that Saudi Arabia grew from a nation of only 3.5 million in 1950 to one with 24.6 million in 2005.⁶⁹⁵ Furthermore, Saudi Arabia is a young nation and 37.3% of its population below 14 years of age group, which compares to 20.8% for the US, and 17.9% for the UK. This is creating two main pressures: the consistent need to create enough jobs and constant increases in per capita earning. This situation is a proof of North's claim, who argues that demographic changes results in institutional forces for changes to be responded to by policymakers by *inter alia*, regulation,⁶⁹⁶ which manifested in Saudi Arabia in high unemployment that created demands for economic growth and job creation.

In the case of Saudi Arabia, it is plausible to suggest that reforms were used as a means for economic policy to attract foreign investment, which was understood as needed to ease pressure on the government budget. However, it was deemed that attracting foreign investment would require a more explicit legal framework and liberal economic conditions to be developed of the kind offered to investors

⁶⁹⁴ The central perception suggested by Niblock and Malik was that 'new sources of investment funding were needed, leading to more substantial economic growth' Niblock and Malik (n 690) 176

⁶⁹⁵ A trend still taking place; the UN estimates that the population of Saudi Arabia will grow to 30.8 million in 2015, 37.2 million in 2025, and 49.5 million in 2050 in Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, 'World Population Prospects: The 2008 Revision'(UN, 2008) <<http://esa.un.org/unpp>> accessed 29 June 2011

⁶⁹⁶ Douglass North, *Understanding The Process Of Economic Change* (CUP1990) 50-58; Casey Mulligan and Andrei Shleifer, 'Population and Regulation' (NBER Working Paper No. W10234, 2004) < <http://ssrn.com/abstract=485722>> accessed 29 June 2011

elsewhere.⁶⁹⁷ Therefore, membership of the WTO was seen as essential to boost the country's image abroad and attract foreign investment.⁶⁹⁸

However, subsequent events changed conditions for the better and reduced the pressure on the government. Increase in oil prices started in 2000,⁶⁹⁹ helping to cover the deficit and turn the budget to surplus.⁷⁰⁰ Interestingly, the pace of reforms did not slow, but speeded up. This is evident in the fact that most of the main regulatory changes needed for economic reform, including the CML, were introduced between 2001 and 2005,⁷⁰¹ which led to the success of the application for WTO membership in 2005.⁷⁰² It is difficult to determine which led policymakers to continue pursuing change; some suggest that it was the slow speed of the political process, while others cite the increased influence of business elites.⁷⁰³

As far as the capital market is concerned, there have been four significant developments. Firstly, the government established the Saudi Arabian Stock Exchange to make it easier to float companies, provide better opportunities for Saudi citizens to invest their money domestically, and increase the capital available to companies for expansion and development.⁷⁰⁴ Secondly, the introduction of the CML recognised the

⁶⁹⁷ Craig Doidge, G. Karolyi and Rene Stulz, 'Why Do Countries Matter So Much for Corporate Governance?' (2007) 86 *Journal of Financial Economics* 1

⁶⁹⁸ See a detailed discussion about factors that affect investments in the Middle East, including membership to TWO, in Ahmet Aysan, Mustapha Nabli and Marie-Ange Véganzonès, 'Governance, Institutions, and Private Investments' ch in Mustapha Nabli (ed.), *Breaking the Barriers to Higher Economic Growth: Better Governance and Deeper Reforms in the Middle East and North Africa* (World Bank 2007)

⁶⁹⁹ The lowest point was \$10 per barrel in 1996, and increased to \$25 in 2001, and reaching \$60 in 2005.

⁷⁰⁰ Saudi oil export revenues sank to only \$34.3 billion in 1998, but they rose to \$46.8 billion in 1999, \$81.7 billion in 2000, \$63.9 billion in 2001, \$65.5 billion in 2002, \$86.1 billion in 2003, and \$106 billion in 2004; Anthony Cordesman, 'Saudi Arabia: Saudi Economic Health' (Diplomatic Traffic, 17 August 2005) < http://diplomatictraffic.com/debate_archives.asp?ID=458> accessed 29 June 2011

⁷⁰¹ 'Altogether, Saudi Arabia enacted 42 laws and created nine new regulatory bodies to bring it into alignment with WTO rules' Niblock and Malik (n 690) 203

⁷⁰² Ibid

⁷⁰³ Ibid

⁷⁰⁴ <http://www.tadawul.com.sa/wps/portal/!ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gDAxN3D0NnN19nAzMPzxBDV0sDKND388jPTdUPTizSL8h2VAQAm2h6Ew!!/d12/d1/L0IHskovd0RNQUZrOUVnQSEhL11CWncvZW4!> accessed 29 June 2011

securities market as a separate industry from banks, giving it an independent regulator. Pre-CML, SAMA had conducted the consolidated supervision of stock markets, insurance, and banks, including having responsibility for the prudential and the conduct of business regulations and supervision.⁷⁰⁵ As a result of the CML, the CMA was established as the main regulator monitoring prudential rules, the conduct of business, and the supervision of transactions and institutions involved in the capital market.⁷⁰⁶

Thirdly, the most notable of the very considerable benefits of the regulatory structure is the creation of a bond market. Historically, Saudi debt instruments did not exist until 1988 when the government decided to issue government bonds but restricted subscriptions and trading to institutional investors.⁷⁰⁷ The issuance of debt instruments by the private sector did not start, however, until 2003 when, for the first, a Saudi company issued bonds with the assistance of the World Bank.⁷⁰⁸ A year after this, a Saudi company listed in the Tadawul (the official and only organised stock exchange) issued the first *Sukuk* (a bond in accordance with Islamic principles) in the domestic market, and several similar issuances followed.⁷⁰⁹ In 2009 the Tadawul launched an automated *Sukuk* and bond trading system to facilitate exchange and the development of a secondary market in debt instruments.⁷¹⁰

⁷⁰⁵ Grais and Kantur (n 683) 30

⁷⁰⁶ Oxford Business Group, *The Report of Saudi Arabia 2008* (Oxford Business Group 2008) 61; and also see Oxford Business Group, *The Report: Emerging Saudi Arabia 2007* (Oxford Business Group 2007)

⁷⁰⁷ Muhammad Al-Jasser and Ahmed Banafe, 'The Development of Debt Markets in Emerging Economies: the Saudi Arabian Experience' (BIS Papers, No 11, 2002) 178-180 <<http://www.bis.org/publ/bppdf/bispap11q.pdf>> accessed 29 June 2011

⁷⁰⁸ Through its private sector lending arm, the International Financial Corporation; see IFC, 'IFC Guarantees First Corporate Bond Issue in Saudi Arabia' (press release, 3 March 2003) <<http://www.ifc.org/ifcext/pressroom/ifcpressroom.nsf/PressRelease?openform&C70CC2A0D0E35AC985256CDE0052116B>> accessed 29 June 2011

⁷⁰⁹ Rodney Wilson, 'Overview of the Sukuk Market' ch. in Nathif Adam and Abdulkader Thomas (eds), *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney 2004)

⁷¹⁰ Vijay Rabindranath and Parthapartim Gupta, 'An Overview – Sukuk Market in Saudi Arabia' (Watheeqa Capital Company, March 2010) <http://www.watheeqa.com/An_Overview_-_Sukuk_Market_in_KSA.pdf> accessed 29 June 2011; also Rodney Wilson, 'The development of

Finally, the current regime aims to widen the backgrounds of investors in securities markets. The CMA allowed foreign investors to purchase financial instruments traded in Tadawul through a swap agreement with authorized firms.⁷¹¹ It is expected that foreign investors will get involved in the Saudi securities markets, since it ranks as the twenty-third largest exchange in terms of market capitalisation among the members of the World Federation of Exchange.⁷¹² By introducing swap agreement, the CMA effectively introduced the concept of derivative as part of securities markets officially for the first time.⁷¹³

These positive developments in security markets, however, have to be viewed in a broader context to understand legal problems that may hinder further development of securities markets in Saudi Arabia.

One negative issue that may constrain the financial system, as argued in the previous subsections, is the influence of the religious perception and concerns. Such negative impact might take place as soon as the Shari'a as applied in Saudi Arabia is to declare the incommutability of essential financial tools that are important for the maturity of the capital market.

For example, Saudi citizens held high expectations from the CML and CMA, but during a stock market crash of over 50% in 2006 this trust by investors was

Islamic finance in the GCC' (Working Paper, Kuwait Programme on Development, Governance and Globalisation in the Gulf States, 2009) <<http://w.lse.ac.uk/collections/LSEKP/documents/Wilson.pdf>> accessed 29 June 2011

⁷¹¹ Decision No. (2-28-2008), dated 17/8/1429H, corresponding to 18/8/2008, permits swap agreements between authorized persons and non-resident foreigners, be they financial institutions or individuals. A stock swap agreement is a derivative in which the underlying asset is a stock, a basket of stocks, or a stock index. A holder of a swap agreement does not legally own the stock, in this case investors do not have any voting or other rights that stock holders do have. It allows exposure to certain stock or markets.

⁷¹² <<http://www.world-exchanges.org/statistics>> accessed 29 June 2011

⁷¹³ Simeon Kerr, 'Gulf Regulators Revive Short-Selling and Derivatives' *Financial Times* (London 10 May 2010)

jeopardised.⁷¹⁴ An objective examination of the situation at that time reveals that there was nothing the authority could do; the problem was with the market structure since there were no investment banks, market makers, independent brokerage firms, or assets management firms.⁷¹⁵ Some of these may be hindered by Shari'a. To be more specific, the existence of a market maker requires certain types of financial contracts such as options, securities lending and forwards to be available in order to hedge a market maker's exposure to a financial instrument's volatility;⁷¹⁶ otherwise, it could easily lead a market maker to bankruptcy by any collapse of stock's prices. The CMA has declared that it is not keen to develop these contracts at the present time because, among other reasons, some of them are prohibited under Shari'a as applied in Saudi Arabia.⁷¹⁷ If this view persists, certain financial contracts will not be seen soon unless Islamic finance specialists can develop forms of these contracts, or the regulator and participants in the market become more tolerant in dealing in them.⁷¹⁸ However, a legal issue with the latter approach is that these contracts will lack legitimacy since they do not comply with Shari'a, and there is nothing in the Basic Law or provided by the King to provide any legitimacy. Simply put, there is an unenforceability risk

⁷¹⁴ AME, 'Saudi Stock Market Crash a Cause for Concern' (*AME*, 20 May 2006) <<http://www.ameinfo.com/86438.html>> accessed 29 June 2011

⁷¹⁵ Khan Zahid, 'Investment Challenges Facing Oil-rich Countries: Example of Saudi Arabia' (OECD Conference, Istanbul, 2004) <<http://www.oecd.org/dataoecd/57/0/28500016.pdf>> accessed 29 June 2011. See also Robin Wigglesworth, 'Capital Markets: Tighter Rules and Better Transparency Welcomed' *Financial Times* (London, 22 September 2009)

⁷¹⁶ Broadly speaking, these contracts permit participants to exchange securities on a temporary basis. For more information as to the development of market structure, see OECD, *Bond Market Development in Asia* (OECD 2001)

⁷¹⁷ Fatwas of Permanent Committee, the General Presidency of Scholarly Research and Ifta' in Saudi Arabia, Group 52, at pp.367-374. Available on the internet at <<http://www.alifta.net/Search/ResultDetails.aspx?lang=ar&view=result&fatwaNum=&FatwaNumID=&ID=7281&searchScope=2&SearchScopeLevels1=&SearchScopeLevels2=&highLight=1&SearchType=exact&SearchMoesar=false&bookID=&LeftVal=0&RightVal=0&simple=&SearchCriteria=allwords&PagePath=&siteSection=1&searchkeyword=216179217136217130032216167217132216167217136216177216167217130032216167217132217133216167217132217138216169#firstKeywordFound>> accessed 29 June.

⁷¹⁸ Besides that, it seems the need for foreign investment is less crucial as a result of the increase in revenues, but there is still need for structural changes; see Anthony Cordesman, 'The Saudi Succession and Economic Stability' (Saudi-US Relations Information Service, 2005) <<http://www.saudi-us-relations.org/articles/2005/loi/050805-cordesman-succession.html>> accessed 29 June 2011

inherent in these contracts. Consequently, it could be argued that the primacy of Shari'a is again restraining the development of securities markets.

To sum up, this subsection points out that the CML was introduced in response to the policy choice of attracting foreign investment. Positive developments in the Saudi securities markets have been identified since the enactment of CML, such as the establishment of a stock exchange, the existence of an independent regulator for securities markets, permission for foreign investors to participate in secondary markets, and the creation of domestic debt markets. Such policy objective fits with the general argument that securities regulations aim to achieve the wider social policy of increasing the allocation of resources. It is argued, however, that the shadow of non-compliance with Shari'a is a threat to the legitimacy of certain financial contracts that are essential for the development of capital markets. The uncertainty of legal rules has been argued may likely increase the legal risk and hence the efficiency allocation of resources. Accordingly, it is highlighted that unless Islamic finance scholars are able to provide substitutes for these contracts, the issue of illegality and incompatibility on the one hand, and the need for moderation may persist for the time being.

F) Concluding Remarks

Saudi Arabia's whole population are Muslim and thus it is expected that Islamic principles and Shari'a will play a major role within the legal context. It has been illustrated above that the two main sources in Islam provide broad principles with respect to contract and transactions and, thus, Islamic jurisprudence has historically relied heavily on the deductive reasoning associated with the four main school of thoughts within the Sunni Muslim.

The Saudi legal system is different from other Muslim countries in that it clearly states that Shari'a is the major source of both law and legitimacy. It is pointed

out that Shari'a as applied in Saudi Arabia has been an obstacle to modernising both the legal system and economic activities. While Saudi policymakers have developed an approach to avoiding any conflict with Shari'a by introducing secular laws and restricting jurisdiction to special committees and tribunals, it is argued that this approach does not fit with current legal understandings of both the importance of the rule of law to Saudi Arabia as a member of the WTO and as a modern state.

Also, it is suggested that the policymakers' approach is responsive rather than proactive. The *ad hoc* approach to problems, overcoming each difficulty faced as it is at the time, will not stop the main problem recurring. This was being illustrated in the case of the CML, whose introduction was a response to internal pressures represented by slow economic growth and high unemployment which made attracting foreign investment a necessity. To that end, a modern capital market was thought essential. However, it is argued that, notwithstanding positive improvement in the capital market, further development is again being hindered by Shari'a as applied in Saudi Arabia. Consequently, it is possible to argue that unless policymakers deal directly with the issue of conflict with Shari'a, it is likely that Shari'a as an obstacle will persist in future development of capital markets law Saudi Arabia.

This study has raised two important points as to the problem with the Shari'a in Saudi Arabia. Firstly, there are no general principles and theories in Shari'a concerning contract, and specifically for obligations. Moreover, it has been declared that codification *per se* is incompatible with Shari'a, and such position of Islamic scholars in Saudi Arabia regarding the codification of Shari'a renders any solution very unlikely in the near future.

Secondly, some modern economic activities are said to be incompatible with the Islamic school of thought in Saudi Arabia. This study differs from the general

stream of researches into financial markets in Saudi Arabia in showing the difficulties with modern practices such as corporations and legal entities instead of merely difficulties with usury, interest and banking activities. The difference is that, unlike with interest where there is clear prohibition in the Qur'an, there is no such direct prohibition on corporations, legal personalities or limited liability *per se* in Qur'an. It could therefore be proposed that it is the rigid application of historic thinking within Islamic jurisprudence to modern economic and social times that creates the difficulty in Saudi Arabia.

Having said that, the question arises as to the reason why other Muslim and Arab countries have more easily adopted modern practices within their legal system while it is such a struggle in Saudi Arabia. A possible explanation is that other Arabs and Muslim countries benefited in this respect from being colonised by the British and Ottoman Empires, and were thus able to, firstly, recognise Shari'a as subordinate to public interest and, secondly, accept the concept of the codification of Shari'a principles.⁷¹⁹

The latter is more acute in the case of contemporary Saudi Arabia since it is still declared unacceptable to codify the Shari'a. Such a process has been denounced as both Western and un-Islamic. However, this perception of incompatibility of such a process of the administration of justice can hinder any benefits sought after modernisation for the legal system in Saudi Arabia in two respects. Firstly, the absence of a legal code or a process of case-precedence within the Saudi system leaves a huge gap due to the absence of any clarity with respect to contracts and obligations, which are essential aspects of any modern economy or for a state

⁷¹⁹ Sfeir (n 657)

claiming to abide by the rule of law.⁷²⁰ Secondly, emphasising that Shari'a is the main source of law and legitimacy in the country begs the question of the legitimacy of the King to legalise practices that are in direct conflict with Shari'a. Questions of legitimacy are not confined to usury, but also to other legal matters such as the legal status of limited liability for legal persons which are not recognised within traditional Islamic jurisprudence.⁷²¹

These two problems could be attributed to a broader legal issue concerning the identity of Saudi Arabia as a geopolitical body, a problem also faced by many Islamic societies after the disintegration of the Ottoman Empire. Critically, it is the question of the relative hierarchy of Shari'a in modern states as a geopolitical entity,⁷²² which has significant effects on other aspects including legal such as the legitimacy of legislative authority in clearly subordinating it to the public interest. Traditional Islamic jurisprudence provides little guidance on this matter. Up until the beginning of the twentieth century, the system of the caliphate was the dominant structure of a political entity in Islamic jurisprudence.⁷²³ The existence of modern states in the Islamic world, however, is relatively a new phenomenon leading to a conflict between Shari'a and questions of nationhood and national interest.⁷²⁴ Admittedly, these are sensitive and difficult questions that must be dealt with carefully but avoiding them

⁷²⁰ A review of policy pronouncements by Saudi Arabia to the rule of law can be found in Marar (n 66)

⁷²¹ Nicholas Foster, 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (2010) 11 *European Business Organization Law Review* 3, 29

⁷²² Up until the beginning of the 20th century, the system of kalifat was the dominant structure of political entity in Islamic jurisprudence. The existence of modern states, however, in Islamic world has been a new phenomenon that raised a conflict between shari'a and national interest.

⁷²³ Javaid Rehman, *Islamic State Practices, International Law and the Threat from Terrorism : A Critique of the 'Clash of Civilizations' in the New World Order* (Hart 2005) 24-26

⁷²⁴ '...the relationship between religious identities and orientations towards authority, community change (or transformation), law, justice, and conflict resolution helps shape the dynamics of a national civil society. Nationhood ... often derives coherence and momentum from the interaction and transformation of component identity and values' in John Paden, *Muslim Civic Cultures and Conflict Resolution* (Brookings 2005) 55

will not solve the practical legal issues which arise; some of which have been identified in this part.

Part II The Capital Market Law Regulatory Regime

From a historical perspective, the CML is the most sophisticated and detailed legislation dealing with securities markets in Saudi Arabia. Its significance could be compared to that of the FS regime in the UK. It encompasses wide-ranging provisions including the establishment of a separate authority, definition of securities and the establishment of a separate judicial system to deal with breaches of its provisions. Given limited space here, the focus remains on those areas related to private enforcement by retail investors for the regulatory requirements of suitability and best execution.

In contrast to the UK where the legislator is transparent in its process of drafting, no consultation papers, policy documents or copies of previous drafts of the CML are available to help to determine either the reasons for or the changes underlying the approaches taken in the final version of the CML. It is therefore fortunate that one of the foreign experts who helped draft the CML, namely Joseph Beach, has published on the subject.⁷²⁵ His article provides insights into the rationale behind many provisions in the CML, including from which legal systems provisions were transplanted. For this reason, Beach's article is central to any attempt to identify the purposes and policies behind the provisions in the CML.

⁷²⁵ Beach (n 68)

A) The Primary Legislation: the CML

Beach points out that the CML was drafted as an enabling law with two fundamental themes in mind: firstly, administrative independence, promoting separate authority and entities to play a specific role in regulations and functioning of securities markets; and secondly, professionalism, where those professionals chosen to oversee the securities markets are charged with developing rules and procedures and running the markets.⁷²⁶ Accordingly, it could be suggested that the CML draftsmen were of the opinion that they should promote a system of self-regulating organisations (or SROs) akin to the system established by the FS regulatory regime in the UK.

The CML established an independent authority, the CMA, which directly reports to the President of the Council of Ministers who is the King himself.⁷²⁷ The CML states that ‘the Authority shall be the agency responsible for issuing regulations, rules and instructions, and for applying the provisions of this Law’.⁷²⁸ To achieve these ends, the CML states that the CMA shall: (1) regulate and develop the exchange, develop and improve systems and entities trading in securities, and develop the procedures that would reduce the risks related to securities transactions; (2) regulate the issuance of securities and monitor dealing in securities; (3) regulate and monitor the works and activities of parties subject to the control and supervision of the CMA; (4) protect citizens and investors in securities from unfair and unsound practices or practices involving fraud, deceit, cheating or manipulation; (5) seek to achieve fairness, efficiency and transparency in securities transactions; (6) regulate and monitor information disclosure of issuers, the dealings of informed persons and major shareholders, and make available information ‘which the participants in the

⁷²⁶ Ibid, 320

⁷²⁷ CML Art.4

⁷²⁸ CML Art.5

market should provide and disclose to shareholders and the public'; and (7) regulate proxy and purchase requests and public offers of shares.⁷²⁹

The first difficulty with the CML is in recognising the objectives of the regulatory framework. In comparison to the UK where the main objectives of the FSMA are clearly defined, the CML is not clear about the objectives which the regulatory regime should aim to achieve.⁷³⁰ A similar approach to that of the FSMA is adopted by providing a set of aims as objectives for the authority,⁷³¹ but the wording of the provision indicates the low levels of the sophistication, clarity and specification. Beach notes various problems generated by the process of drafting, which was initially proposed in English, then translated into Arabic and circulated to different government agencies for feedback. The feedback in turn was translated back into English.⁷³²

Several different issues can be identified with the outcome of the process in the CML. Firstly, there is no clarity of the objective itself. The wording of the CML provides that the objective of the CMA is to exercise its powers and to implement the CML. The functions stipulated in the CML are not objectives of the regulatory framework but a mix of elements to be considered (fairness and efficiency, for example) by the CMA. Put simply, the objective of the CMA is to implement the CML and in exercising its powers it has to consider different factors including, *inter alia*, fairness and efficiency.

Secondly, confusion between the objectives, the regulator's tasks and the elements to be taken into account is manifested in the way that the CML provides for

⁷²⁹ An official full translation of the CML to English is available at the following link:

<http://www.cma.org.sa/cma_cms/upload_sec_content/dwfile20/Capital%20Market%20Law.pdf>
accessed 29 June 2011

⁷³⁰ The way of stating the objectives of the authorities is in contrast to the SEC, see the at
<<http://www.sec.gov/about/whatwedo.shtml#laws>> accessed 29 June 2011

⁷³¹ CML Art.5

⁷³² Beach (n 68) 325

the work of the CMA to be evaluated. Article 5 (b) states that ‘the regulations, rules and instructions issued by the Authority shall be effective in the manner prescribed under their provisions’. It is unclear whether this means that the effectiveness of each provision should be considered on its own merit in isolation from criteria such as fairness and efficiency imposed on the CMA, or if those regulations and rules should be balanced against efficiency and fairness. For instance, should the provision related to suitability be considered on their fairness and efficiency or by taking the efficiency of the framework into account?

Thirdly, as far as investor protection is concerned, the CML is silent as to elements to be used in judging the fairness and soundness of a given practice; for example, whether or not fairness should be considered from the provider’s or investor’s point of view. Furthermore, there is no guidance upon which the CML should side with in the event there are reasonable grounds on both sides.

Fourthly, it is interesting to note that there is no mention in the objectives of the authority of the reputation of the Saudi economy or the promotion of the securities market abroad. Yet, as explained above, the aim for the reform was to attract foreign investors. Nor does it emphasise maintaining the confidence of investors as it is the rationale for the protection of investors.

Finally, the role of the exchange is unclear within the CML framework.⁷³³ Beach suggests that the role of the Exchange was intended to be similar to that of a SRO in bringing participants opinions and expertise in dealing with the CMA and to organise the participants themselves.⁷³⁴ Given the draftsmen are American, it is likely that they relied on the U.S. experience with the NYSE and its rulebook in not only detailing the duties of brokers, but also in developing those duties to respond to future

⁷³³Article 5 (b) states that the CMA ‘may publish a draft of regulations and rules before issuing or amending them’.

⁷³⁴Beach (n 68) 336

challenges that would be dealt with better by participants.⁷³⁵ However, the Saudi experience since the enactment of the CML in 2003 suggests a different path has been taken from those of the U.S. The exchange-rules if they exist are not made accessible by the public and therefore investors are not able to determine the required standards of professional behaviour.⁷³⁶ Moreover, in contrast to the US experience where the regulatory requirements of suitability and best execution are imposed through the exchange-rules, they are imposed on brokers by the Implementing Regulations published by the CMA. Thus, since it could be argued that the way the regulatory duties are imposed within the CML framework is different from the US experience, it follows that the CML regulatory framework may be unable to develop effective professionalism through SROs in a similar way to the US. It is likely that the Saudi experience of the role of the exchange as an SRO is more about bringing the perspective of participants, rather than a means to regulate participants among themselves.⁷³⁷

Acknowledging some of these criticisms, Beach attempts to excuse himself by a heavy reliance on problems of translation during the process of drafting, and the need to ‘give the Authority ... the flexibility to develop and adapt as the Saudi capital market evolves’.⁷³⁸ For this reason, the CMA, argues Beach, was given various powers including the issuance of regulation, oversight of the exchanges, supervision

⁷³⁵ See ch 2 Part III

⁷³⁶ In its websites, under the heading of the rules and regulations of the Exchange (Tadawul), there is only an introduction, a snapshot of CML chapters and requirements for non-Saudi to open an account for trading, <http://www.tadawul.com.sa/wps/portal!/ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TIwMLf3czA0_vIKegIBN_QwNXO6B8JJK8e0CYqYGniU-wUXCAI7GBpxEB3X4e-bmp-gW5EeUATNtVlg!!/dl2/d1/L0IDUmlTUSEhL3dHa0FKRnNBL1ICUlp3QSEhL2Vu/> accessed 29 June 2011

⁷³⁷ See Chris Doyle, ‘Self Regulation and Statutory Regulation’ (1998) 8 Business Strategy Review 35, 40

⁷³⁸ Beach (n 68) 325

and monitor listing of securities.⁷³⁹ However, the main problem is the absence of institutionalised checks on the powers provided to the CMA, or indeed any grounds to criticise the practice of the authority. Except for its power to suspend trading, which must refer to the ministry for suspension of more than one day, no checks or limitation are imposed upon the CMA, except with regards to fairness and efficiency. Given that it is not binding to consult or to exercise any analysis, it could be argued that there is a possibility that these extensive powers may result in negative results for securities markets, such as regulatory capture of the CMA.⁷⁴⁰ Moreover, ambiguity and lack of legislative guidance make it very difficult to assess and evaluate the CMA's efforts including its rule-making powers; a difficulty faces this study.

B) The Authority: The CMA

The CMA enjoys many powers conferred to it by the CML and is restricted only by its jurisdiction, which is founded on the traded instrument, namely a 'security'.

Article two specifies that, for the purpose of the CML, the term 'security' includes 'convertible and tradable shares of companies',⁷⁴¹ 'tradable debt instruments issued by companies, the government, public institutions or public organisations',⁷⁴² 'investment units issued by investment funds',⁷⁴³ 'any instruments representing profit participation rights, any rights in the distribution of assets; or either of the foregoing',⁷⁴⁴ and 'any other rights or instruments which the Board determines should be included or treated as Securities' in order to 'further the safety of the market or the

⁷³⁹ CMA art.6

⁷⁴⁰ Beach indirectly recognises the problem but argues that the CML is an 'enabling law, relying of the Authority to ... limit its powers under the law... the Authority needs to carefully consider how best to exercise its authority while still maintaining its autonomy', Beach (n 68) 326

⁷⁴¹ CML Art.2(a)

⁷⁴² CML Art.2(b)

⁷⁴³ CML Art.2(c)

⁷⁴⁴ CML Art.2 (d)

protection of investors’.⁷⁴⁵ Article three specifically excludes ‘commercial bills such as cheques, bills of exchange, order notes, documentary credits, money transfers, instruments exclusively traded among banks, and insurance policies’ from the scope of Article two.⁷⁴⁶ Moreover, the CMA has the right to exclude from the definition of security any instrument which is already deemed as a security since the CML states that the CMA may ‘exempt from the definition of Securities rights or instruments that otherwise would be treated as Securities’ under previous paragraphs if it is believed that ‘it is not necessary to treat them as Securities, based on the requirements of the safety of the market and the protection of investors’.⁷⁴⁷

While admitting that the approach of the CML invests extensive powers into the CMA under its own jurisdiction, Beach insists that adopting such approach was necessary for certainty and practicality within the Saudi context on three grounds.⁷⁴⁸ Firstly, it is doubtful that a litigation-driven definition of security, as in the US, will work within the Saudi judicial system since there is no prohibition on *ex post facto* regulations or actions by a government entity within the concept of law in Saudi Arabia.⁷⁴⁹ Secondly, both detailed lists and a single definition were rejected because it would be too vague and may result in a litigation-driven approach.⁷⁵⁰ Thirdly, Saudi administrative law is already accustomed to investing too much power in a single authority. Simply put, the draftsmen invested so many powers in the CMA, including amending its own jurisdiction, because litigation development is not workable and, hence, wanted to avoid litigation and any means that facilitate litigation by conferring so much powers to the authority, which was acceptable in Saudi Arabia.

⁷⁴⁵ CML Art.2 (e)

⁷⁴⁶ CML Art.3

⁷⁴⁷ Ibid. the power is provided for the board of the CMA.

⁷⁴⁸ Beach (n 68) 322

⁷⁴⁹ Ibid

⁷⁵⁰ Ibid, 321

However, Beach's account of the investiture of so many powers in the CMA, including its own jurisdiction, could be criticised on many grounds. Firstly, it is evident that markets and participants may outpace regulators. Secondly, in current financial markets difficulties may arise as to complex financial products that are very difficult to categorise as securities given they cut across many financial industries, which is explained further below. Thirdly, and most importantly, a key element of the rule of law is that the law be known and that it be impartially applied. Article 38 of the Basic law states that 'There shall be no punishment except for acts committed subsequent to the coming into force of the organizational law'. Accordingly, if CMA decisions would involve penalties or financial burden concerning contracts concluded before that specific kind of contract was brought within the jurisdiction of CML by the CMA, an argument could be made that this may be against the rule of law and the primacy of the Basic Law in Saudi Arabia.⁷⁵¹ Finally, reliance on previous actions by the government should not have guided the draftsmen of the CML. In fact, it could be argued that previous actions by the government should not be used as a rationale for investing much power here, since Saudi Arabia was about to become a member of the WTO and thus needed to observe the rule of law, which had been absent hitherto.⁷⁵²

Consequently, it could be argued that this approach, which invested too much power in the authority, should have been avoided and a litigation-led definition adopted instead. Such an approach could have fitted easily within the CML framework, since the same line of reasoning used to reject a litigation-driven

⁷⁵¹ 'For the purpose of the rule of law as certainty, ... the three following principles are constitutive of the idealtype: the law is prospective; the law is clear; the law is general' in Luc Tremblay, *The Rule of Law, Justice, and Interpretation* (McGill-Queen's University Press 1997) 150; Daniel Troy, *Retroactive Legislation* (AEI 1998) 18; and Keith Culver K, *Readings in the Philosophy of Law* (Broadview Press 1999) 16

⁷⁵² Hossein Esmaeili, 'On A Slow Boat Towards The Rule of Law: The Nature of Law in the Saudi Arabian Legal System' (2009) 26 *Ariz. J. Int'l & Comp. L.* 1

definition are also the same reasons used to establish a specific tribunal to settle disputes under the CML framework.

C) The Dispute Settlement

It was noted in the previous section that dispute settlement for brokerage business was taken out of the jurisdiction of Shari'a courts and ascribed to the CSBD. The difficulty here, however was that the need for the modernisation of securities markets in Saudi Arabia required the introduction of certain criminal charges associated with certain fraud activities. Hence, the option of returning securities' jurisdiction to Shari'a's courts was rejected on grounds that they were unsuitable for enforcing a system of *malum prohibition* regulations criminalizing behaviour which may on the face of it not be inherently wrong.⁷⁵³ Thus, there was an understanding that there was a need for a special dispute settlement mechanism separate from Shari'a courts.

An option considered at the time was the creation of a centralised investor compensation system where investors would receive redress from the government who would then take actions against the offender.⁷⁵⁴ However, such a system was rejected on the grounds that it would reduce the incentive for private enforcement.⁷⁵⁵ To maintain incentive for private enforcement, it was deemed a private cause of action for a breach a suitable instrument.⁷⁵⁶ Given that a private cause of action was introduced in the CML, it is reasonable to maintain that private enforcement by investors is considered part of the CML framework.

⁷⁵³ Beach (n 68) 318

⁷⁵⁴ Ibid, 328

⁷⁵⁵ Ibid

⁷⁵⁶ Ibid

The CML created an independent committee to supplant Shari'a courts in the process of resolving securities disputes resolution, the Committee for the Resolution of Securities Disputes (henceforth CRSD).⁷⁵⁷ The CML states that the CRSD:

‘shall have jurisdiction over the disputes falling under the provisions of this Law, its Implementing Regulations, and the regulations, rules and instructions issued by the Authority and the Exchange, with respect to public and private actions’.⁷⁵⁸

Hence, the CRSD jurisdiction is wide enough to include claims against decisions and actions taken by the CMA or the exchange, private cause of actions and enforcement, and criminal actions.⁷⁵⁹ The CML also provides for appeal against a decision by the CRSD to a special Appeal Panel, within thirty days.⁷⁶⁰

While the CML confers on the CRSD the jurisdiction over private and public actions, it separates private and public enforcement as far as procedure is concerned. Firstly, it differentiates between awards issued in favour of the authority and those for private persons. The latter would be enforced through normal civil proceedings similar to judicial judgement, while the former would be dealt with by the government agency responsible for the enforcement of judicial judgments.⁷⁶¹ Secondly, there is no active role for the CMA in private enforcement. The only role is that the CML states that no complaints shall be brought before the CRSD until they have been lodged with the CMA for ninety days, which could be shortened or waived by the CMA.⁷⁶² This contrasts with the UK, where the FSMA provides for an active role for the authority in private enforcement through different provisions such as

⁷⁵⁷ CML Art.25(1)

⁷⁵⁸ Ibid

⁷⁵⁹ CML Arts.27, 35, 66 and 66

⁷⁶⁰ CML Art.25(h)

⁷⁶¹ Ibid

⁷⁶² CML Art.25(e)

ss.382 and 384 which gives right to the authority to seek compensation on behalf of authorised or unauthorised persons.⁷⁶³

To sum up, the CML established a special tribunal to deal with disputes resulting from a breach of a provision in the CML regulatory framework. This tribunal has a jurisdiction over criminal offences provided in the CML, actions taken by the CMA and private action by investors. It is noted that private enforcement is part of the regulatory framework established by the CMA and therefore it could be argued that there is a role for private enforcement of the regulatory requirement of suitability and best execution. A detailed analysis of the private enforcement within the CML framework is provided in the next section.

D) Private Enforcement

Given that private enforcement is part of the CML framework, it could be suggested therefore that private enforcement within the CML is considered an instrument in achieving policy objectives. However, it should be emphasised that the instrument employed is different from the one used in the FSMA framework. The private enforcement regime of the CML was built similar to the one used in the U.S, presumably for two reasons: the first being the reliance on help from American experts to draft the CML; and secondly, the institutional design of financial markets dividing them into three separate industries: banking, securities and insurance. However, the discussion below suggests that notwithstanding the existence of a regulatory private cause of action similar to the US, the CML regulatory regime may rely on traditional tort action in the private enforcement of the regulatory requirements of suitability and best execution. In addition, the complexity of the American approach requires an established judiciary system with high trust, but in the

⁷⁶³ The FSMA s.382 and 384

Saudi case trust is lacking for the judiciary and courts as well as the absence of published judgement which can spell out the interpretation and the role of courts.

To begin with, the CML provides two different routes for disputes leading to CRSD depending on the nature of the complaint. The first is where an investor is willing to bring an action against a licensed broker. A complaint should start at the formal exchange (Tadawul), which enjoys the jurisdiction of ‘settling disputes among members of the Exchange and between the members and their clients’.⁷⁶⁴ The CMA has published a non-exhaustive list of disputes within Tadawul’s jurisdictions, including problems in executing an order placed by a customer, refusal to provide brokerage services to a customer, or mismanaging a customer’s account on technical grounds.⁷⁶⁵

The second route is through the CMA itself. That includes complaints against licensed brokers as well as unlicensed and any other cause of action provided by the CML. The CMA has published a non-exhaustive list for complaints falling within its jurisdiction, which include cancelling or suspension of a service without referring to the client, broker’s failure to manage the portfolio due to defective and inefficient procedures rather than technical failure, violations of the CML’s provisions, breach of Implementing Regulations governing brokers’ activities, levying of fees or commissions exceeding the established ones, or objection to low levels of service provided by the authorized persons.⁷⁶⁶ The CMA permits investors to make complaints electronically through the CMA’s website.⁷⁶⁷

⁷⁶⁴ CML Art.23(a)

⁷⁶⁵ CMA, “How To Make A Complaint’ (CMA publication No.11) 4-5 <http://www.tadawul.com.sa/static/pages/en/InvestorGuide/PDF/IG_11.pdf> accessed 29 June 2011

⁷⁶⁶ The list is accessible through the Internet at the following link:

<<http://www.cma.org.sa/en/FormsSite/Pages/HowtoFileaComplaint.aspx>> accessed 29 June 2011

⁷⁶⁷ Ibid

Inevitably, there are some overlaps between the jurisdictions of Tadawul and the CMA with regards to investor complaint. The CMA indicates that it would reject any complaint submitted which is within the jurisdiction of Tadawul, and requires investors to submit initially a request to Tadawul in case of any doubt as to the appropriate authority to consider a dispute.⁷⁶⁸ On proper examination, both the CMA and Tadawul routes are merely informal means to settle disputes since an investor lodging a complaint with Tadawul or the Authority still enjoys the right to bring an action before the CRSD if the complaint is not solved within a period of time by agreement between the investor and the service provider. The difference between the two routes is that the CML states that the CMA is not permitted more than ninety days to consider a complaint, otherwise an investor can bring an action directly to the CSDR.⁷⁶⁹ In contrast, the CML is silent as to the limit of time that Tadawul is permitted in considering a complaint. However, since the CMA is a higher authority, it could be reasonable to argue that what binds it should also be binding on the exchange, and thus there should be limited period of ninety days.

There are two further areas where the CML is silent as to investors' complaints. First, in the event that Tadawul decides that a complaint falls outside of its jurisdiction, whether the ninety days limitation is fully available to the CMA or should be reduced by the time taken by the Exchange in considering the complaint. Secondly, in the event that Tadawul refuses to refer a case within its jurisdiction to CRSD, it is unclear whether an investor is permitted to bring the action directly to CRSD or has to lodge the complaint again with the CMA. The CML, CMA and Tadawul are all silent on these issues.

⁷⁶⁸ Ibid

⁷⁶⁹ CML Art.25(e)

The importance of the previous paragraphs to this study arises from the fact that both of the disputes settlement routes are applicable in case an investor is willing to sue for a breach of the regulatory requirement of “best execution”.

The CML also provides for statutory private causes of action. It provides for four private causes of action for damages. Firstly, it provides for a cause of action to recover damages resulting for a material misrepresentation in a prospectus.⁷⁷⁰ Secondly, a private cause of action is available in the event that an individual makes (or is responsible for another making) an untrue written or oral statement of material fact, or a material omission, in connection with another’s purchase or sale of a security.⁷⁷¹ Thirdly, a private cause of action for a person who, by any intentional acts, manipulates the price of a security;⁷⁷² and, finally, a private cause of action is provided against unlicensed brokers.⁷⁷³ Among these, this study examines the second and the final private causes of actions, which are relevant to the questions posed in this research.

As with the general prohibition in s.19 of the FSMA, the CML provides that any agreement reached with unlicensed brokers is unenforceable, but the unlicensed broker has the right to recover any money or property transferred under the contract.⁷⁷⁴ The other party, however, may recover any money or property provided that it also returns any money or property received. To avoid any conflict with Shari’a courts, the CML states that the CRSD has the sole jurisdiction over these matters.⁷⁷⁵ However, as far as remedy is concerned, in contrast to the FSMA where the right to

⁷⁷⁰ CML Art.55(a)

⁷⁷¹ CML Art.56

⁷⁷² CML Art.57

⁷⁷³ CML aAt.60(b)

⁷⁷⁴ Ibid

⁷⁷⁵ Ibid

compensation is an alternative remedy available to a consumer, there is no such alternative right in the CML.

Consequently, the general prohibition with regards to unlicensed brokers is detailed out in art.32 which defines a broker as a person acting as a broker, not one who seeks the status of a broker. The basic test for deciding whether a company or an individual is a broker is whether or not they are undertaking one of a list of activities which includes acting in a commercial capacity as an intermediary in a securities trade,⁷⁷⁶ offering securities accounts to others,⁷⁷⁷ acting as a portfolio manager,⁷⁷⁸ acting as a market maker,⁷⁷⁹ acquiring or placing securities for an issuer,⁷⁸⁰ or acting as an intermediary, in a commercial capacity, in interest, currency or share swaps.⁷⁸¹ The CML provides the CMA with powers to exempt from licensing any dealer-like group which needs to be regulated.⁷⁸²

Some comments need to be made about the way brokers are recognised according to the CML. Firstly, emphasis is placed on the action and the commercial capacity of a person, which effectively would rule out from the scope of the CML those cases of fraudulent actions by a person representing himself as being engaged in buying and selling securities but without so acting.⁷⁸³ Secondly, it is argued that the CML is broad enough to cover the commercial behaviour of financial service providers other than brokers, such as financial planners.⁷⁸⁴ However, as far as private enforcement is concerned, it is very difficult to accept such a claim, given that

⁷⁷⁶ CML Art.32(a)1

⁷⁷⁷ CML Art.32(a)2

⁷⁷⁸ CML Art.32(a)1 and Art.32(b)

⁷⁷⁹ CML Art.32(a)3

⁷⁸⁰ CML Art.32(a)4

⁷⁸¹ CML Art.32.(a)5

⁷⁸² CML Art.32(c)

⁷⁸³ Beach notes that the original drafts of CML borrowed from the UK a part that covered individuals who hold themselves out as engaged in buying and selling securities. However, the final draft deleted this provision. Beach does not provide any justification or rationale for this, Beach (n 68) 334 footnote 134

⁷⁸⁴ Beach, *ibid*, 335

advising on a security is not an act that requires obtaining a licence. There might be a cause of action for a fraudulent financial advice, but there is no duty upon financial advisers to apply for a licence. It follows that while suitability is imposed by the CML regulatory framework upon financial advice provided by a broker, this approach may exclude financial advice on a security that is not provided by a broker.

Consequent to this approach with regards to the definition of brokers, it could be argued that the system established by the CML is narrow in comparison with the UK. It is narrower since it focuses on the activities performed by brokers but omits the same activities or services normally associated with brokers but not provided by them, such as financial advice.

The other important cause of action is for recovery of damages against an individual who makes, or is responsible for another person making, written or oral statements of material facts which is untrue, or a material omission, in connection with the purchase or sale of a security.⁷⁸⁵ The CMA permits an investor to seek damages and provides details as to the remedy and the requirements for an investor, or a customer, to vindicate his or her right.

For a successful cause of action according to the CML, the plaintiff must prove that he or she had no knowledge that the misrepresentation was untrue (or omitted), that they would not have bought or sold (or bought or sold at the transaction price) if they had known, and that the person who made the misrepresentation (or was responsible for it) knew that it was untrue or was aware of a substantial likelihood that the representation was false.⁷⁸⁶ The requisite state of mind is actual knowledge or reckless disregard of the truth, and materiality is proven by showing that the statement or omission affected the price at which the investor would have purchased the

⁷⁸⁵ CML Art.56(a)

⁷⁸⁶ CML Art.56(a)

security.⁷⁸⁷ Civil damages for this cause of action would amount to the difference between the price actually paid for the security and either the value at the time of the suit, or any price of the securities prior to filing the suit with the CMA.⁷⁸⁸ The CMA provides the defendant in such an action with a right for a claim to reduce the measures of damages by showing that all or any portion of the decline in value of the security was not caused by the malfeasance in question.⁷⁸⁹ All defendants are jointly and severally liable.⁷⁹⁰ The CMA also states that any complaint must be instituted within one year after the complainant reasonably should have known of the facts which gave rise to the complaint.⁷⁹¹ In any event, suits based on this private cause of action are barred five years after the occurrence of the violation.⁷⁹²

This cause of action, also known as the anti-fraud provision, is articulated in art.56 of the CML and it is reasonable to expect it would form the cornerstone of any action brought by an investor for a breach of the regulatory requirement of suitability. It is reasonable given that this provision is based on U.S. securities law and that the suitability requirement has been enforced by federal courts in the US on reliance on the anti-fraud provision in US securities law.⁷⁹³ Moreover, the provisions of the CMA discussed above are similar to those principles in common law in requiring the materiality of the statement and reliance by the plaintiff on it for a cause of action to be successful. To the credit of the CML, the provisions are clearly stated and

⁷⁸⁷ CMA Art.56(c) states that ‘for the purpose of this Article, a statement or omission shall be considered related to an important material fact in accordance with the standard provided for in paragraph (a) of Article 55 of this Law’. Art.55 (a) states that ‘a statement or omission shall be considered material for the purposes of this paragraph if it is proven to the Committee that had the investor been aware of the truth when making such purchase it would have affected the purchase price’.

⁷⁸⁸ CML Art. 56(b) refers Art.55(e) for the measure of damages.

⁷⁸⁹ CMA Art.55(e)

⁷⁹⁰ CML Art.56

⁷⁹¹ CMA Art.58

⁷⁹² Ibid

⁷⁹³ The Securities Act of 1933 §11 (codified as amended at 15 U.S.C. § 77k (1998))

identified which is advantageous in overcoming any ambiguity with Shari'a principles as applied in Saudi Arabia to anti- fraud behaviour.

However, there are some important reservations that need to be considered. Firstly, the defence available to the defendant in this cause of action concerning the right to seek reduction in the amount of damages is broad; it is not confined to negligence constituted by the plaintiff, but also for any reduction in the price of the security in the market. Such defence could be questionable in the event that the defendant intentionally aimed to defraud the investor. Secondly, art.56(a) states that 'it is not required that a relationship exists between the claimant and the defendant'. Such a statement could be suggested to attempt to include relationships that are not contractual. But it is unclear as to what the position of the CMA framework is concerning the legal requirement of proximity in the relationship between the plaintiff's damages and the defendant's act. Thirdly, the CML requires the statement or omission to have affected the price at which the investor would have purchased the security. But what if a broker provides an unsuitable advice as to the strategy adopted rather than the security chosen. In such a case, it is unlikely that an investor would be entitled to compensation. Finally, it is unclear whether or not the time-limitation imposed by the CML would extend to non-statutory causes of actions, such as tort or general principles of fraud.

Moreover, by adopting the American approach, the CMA brought into the Saudi legal context an unresolved area of securities law from the US into Saudi Arabia in relation to the private enforcement of a breach of regulatory requirements. Particularly, an investor entitlement to seek compensation against a service provider in case of tort, given that there is no provision to the contrary in the CML.

As far as a tort action for unsuitable financial advice is concerned, there are some important uncertainty issues. In principle, it is very uncertain as to how a financial adviser is to be held liable under Shari'a. Such uncertainty could be attributed to the difficulty of ascertaining the position of previous Shari'a scholars who have dealt with nominal contracts referring to modern professional services. To illustrate this with reference to the liability of doctors, Al-Mushaigih, evaluates various positions and concludes that three main factors would determine whether or not a doctor is liable: the knowledge of the doctor, the knowledge of the patient of the inexperience of the doctor, and a fault by the doctor.⁷⁹⁴ In particular, Al-Mushaigih argues that a knowledgeable doctor who makes a mistake is not liable so long as he or she has shown reasonable care.⁷⁹⁵ Al-Mushaigih furthermore argues that there are two positions for Shari'a in this case. Firstly, in the event that the doctor neglects to take into account important information relevant to the patient as agreed by other doctors, the doctor is liable.⁷⁹⁶ Secondly, where a mistake happens even though enough information had been gathered, there are two views under Shari'a some of which hold him liable and others not.⁷⁹⁷ Thus, by analogy to doctors liability, it could be suggested that different opinions exist on the position of Shari'a as applied in Saudi Arabia to the liability of financial adviser depending on various factors which make it difficult to be applied to a specific case.

Once an attempt is made to apply these views of Shari'a to professional financial services, different difficulties could be expected. The completely different views of Shari'a on the matter of liability make it difficult to determine which view a

⁷⁹⁴ Khalid Al-Mushaigih, 'The Liability of a Doctor Under Shari'a' (2001) 6 Al-Adl 1. Al-Adl is a journal concerned with legal issues published by the Ministry of Justice in Saudi Arabia. The Article is accessible through the internet at <http://212.70.50.62/Adl/topic_d_d.aspx?ID=6&IDd=118> (accessed 29 June 2011)

⁷⁹⁵ Ibid, 21

⁷⁹⁶ Ibid, 11

⁷⁹⁷ Ibid, 12-13

judge would rely on to form his judgement. Furthermore, with reference to the vital information which needs to be considered if a doctor is liable, Shari'a scholars, according to Al-Mushaighi, do not refer to general practice and other medical opinions; rather, they have developed twenty-one factors which a doctor should take into account in treating his or her patient.⁷⁹⁸ Al-Mushaighi also does not discuss the position of Shari'a with respect to principles and guidance published by general medical associations to the liability of a doctor. Consequently, it could be suggested that there would be a very high level of uncertainty if Shari'a principles as applied in Saudi Arabia were applied to modern practices of financial advice.

This prediction of a high level of uncertainty is supported by the approach that CSBD has developed in relation to liability in tort. The CSBD's approach is akin to the liability in tort under civil law, which is different in reasoning and style from the Shari'a approach mentioned in the previous paragraph. According to CSBD, it is recognised that the liability of a defendant for damages, whether upon contract or tort, requires a plaintiff to establish that there was a breach by the defendant, that the plaintiff suffered damage, and that a relationship exists between the breach and the damages.⁷⁹⁹ The published principles by CSBD unambiguously affirms the position that in principle, compensation aims to return the injured party to the position occupied before the breach.⁸⁰⁰ The amount of compensation then will be determined on the basis of the value of the damage, the breach itself, the behaviour of the plaintiff and the plaintiff's contribution to the damage.⁸⁰¹ It is also affirmed that no compensation would be granted for mere breach of an obligation without actual

⁷⁹⁸ Ibid, 5. footnote 21

⁷⁹⁹ Principles 725 in decisions 27/1425 and 59/1425 (2005) in SAMA, *Banking Disputes: Litigation Procedures Before The Committee of Banking Disputes and The General Principles that Have Approved* (SAMA 2006)

⁸⁰⁰ Principle 732 in decision no. 103/1425 (2005)

⁸⁰¹ Ibid

damage, unless there is a compensation clause.⁸⁰² Accordingly, it could be suggested that this approach to tort in disputes over financial transactions is clearer than those provided by Shari'a as applied in Saudi Arabia. It is thus reasonable to expect CRSD to follow the general principle laid down by CSBD given the uncertain application of Shari'a and absence of any guidance as to tort in the CML.

Consequently, it could be argued that, for a successful action for a breach of the regulatory requirement of suitability in tort, a claimant must establish that there is a breach by the adviser, that the claimant had suffered a loss, and that there is a relationship between the loss and the breach. Similar requirements are imposed in cases of a broker in a breach of best execution.

However, both tort and a private cause of action according to art.56 of CML may lead to difficulties in practice with private enforcement of the suitability requirement in particular. It was illustrated in the previous chapter that, through civil litigation American courts developed the concept of a private cause of action for suitability through the anti-fraud provisions of the Securities and Exchanges Act 1934.⁸⁰³ As far as the suitability obligation is concerned, a difficulty was the theoretical justification for imposing the regulatory requirements of suitability on an investor-broker relationship. American jurisprudence developed four theories in justifying this approach by the American courts.

The first of these is the common law of agency. Under common law, stockbrokers are agents for customers for whom they execute trade. Agents have long been held to owe a specific duty to provide material information about the matters entrusted to them. The suitability obligation requires a broker to make a disclosure to the customer that may deter the customer's purchase of a security and to decline to

⁸⁰² Principle 746 in decision 256/1425 (2005)

⁸⁰³ Gedicks (n 341)

sell certain securities altogether on the basis of reasonable grounds. Thus, since a broker is an agent, the agent owes fiduciary duties of care and loyalty to the customer, including the duty to advise a customer whenever a recommended transaction is not suitable. The problem with this approach is that fiduciary law is based on the particular situation of the context of a specific relationship which makes it very difficult to construct general principles for the application of suitability.⁸⁰⁴

Secondly, suitability is imposed through the theory of special circumstances. This provides that a broker owes a fiduciary duty to a customer whenever they create a relationship of trust and confidence in their dealing with that customer. This relationship is recognised when a broker solicits a customer to purchase a security, or acts as a salesman. The practical importance of this theory in the US context is that it extends the application of suitability to a relationship where agency is not recognised, such as dealers.⁸⁰⁵ The disadvantage of the theory is that it recognises the fiduciary duty only when the circumstances of the relationship seem to demand it. While in the former theory suitability associated with agency is a matter of law, under this theory suitability is a question of fact, which concerns whether or not the circumstances of the case amount to the establishment of a “trust and confidence” relationship.

Thirdly, the duty of suitability is imposed on the basis of the shingle theory of a broker-dealer, which holds that merely by identifying themselves as brokers and dealers in securities – by ‘hanging out a shingle’ - a broker or a dealer impliedly represent that they will deal fairly with the public and be bound by standards imposed on other professionals.⁸⁰⁶ The 1934 Act provides that no broker or dealer may effect or solicit securities transactions unless he or she is a member of a registered securities association or registered ‘national securities exchange’. Within this understanding,

⁸⁰⁴ Ibid, 553

⁸⁰⁵ Ibid, 555

⁸⁰⁶ Louis Loss, ‘The SEC and the Broker-Dealer’ (1948) 1 VAND. L. REV. 516, 518

suitability is recognised to be imposed by different SROs on their members, although these SROs differ in the process, history and origin as to how the suitability rule is incorporated.⁸⁰⁷ This statutory obligation is reinforced by an American common law doctrine of ‘holding out’, which provides that one who represents himself or herself as possessing expert knowledge and skill is held to the higher standards of care consistent with the representation. This doctrine applies to any person who provides services to others in the practice of a profession or skilled trade. Thus, by holding themselves out as experts in securities and securities markets, brokers are held to fiduciary standards of care in accordance with the standards in the industry with respect to the recommendations they make to their customers. As the recommendation of an expert, it carries with it an implied representation that the security meets the customer’s ‘particular needs and investment objectives’. The benefit of this theory is that it holds a broker to suitability as soon as a broker goes into business, regardless of whether or not those dealing are in an agency relationship as broker or a principal relationship as a dealer. While the advantages of the shingle theory appear to avoid the uncertainty of case-by-case analysis inherent in the former two theories, it can be argued to have shifted the uncertainty and case-by-case analysis weakness from the legal point of whether or not to impose the regulatory duties, to determining the content of those duties.⁸⁰⁸

Finally, a claim for a fraud could be raised, but even here every element of fraud must be proven, including reasonable reliance. The unsuitability claim is based on the assertion that the broker made an untrue statement of a material fact or omitted to state a material fact necessary so that the information would not be misleading.⁸⁰⁹

⁸⁰⁷ Gedicks (n 341) 558-559

⁸⁰⁸ Ibid, 561

⁸⁰⁹ Roger Reinsch, J. Reich and Nauzer Balsara, ‘Trust Your Broker: Suitability, Modern Portfolio Theory, and Expert Witnesses’ (2004) 17 St. Thomas L. Rev. 173, 179

The limitation of this approach is obvious; it restricts the duty of suitability to fraudulent financial advice and thus restricts the scope of private action.

In retrospect, the Saudi framework would not be able to apply the different theories developed in the U.S. because of the way the CML has been introduced. Firstly, it is unlikely that Saudi financial law would develop a reasoning in line of the shingle theory, since there is no prohibition in the CMA on financial advice by unauthorised persons, nor is there a requirement of registration for advising on securities. Secondly, the private cause of action introduced in the CML is similar to the American approach, which relates unsuitable advice to fraud. This approach would be difficult to provide effective private enforcement for suitability within the Saudi context since it not only involves a higher level of proof of different elements such as the knowledge of the provider and reliance, but also fails to take into account cases of negligent unsuitability.

Consequently, it could be argued that the easiest theory to develop within the Saudi context is likely to be agency theory. Previous decisions by the CBDR affirm its recognition of the existence of an agency relationship between banks acting as brokers and their customers.⁸¹⁰ It is also recognised that a bank, acting as an agent, must behave with good faith and as expected from any professional in their industry.⁸¹¹ In one case, CBDR held that for not following the instruction given by the client in selling shares that bank failed to act as expected from an agent in that context and, hence, obliged the bank to return the shares disputed, their multiplies and profits.⁸¹²

In short, this section points out to the importance of private enforcement within the CML regulatory framework. It reviews the instrument used to provide

⁸¹⁰ For example Principle 791 decision 42/1424 (2004)

⁸¹¹ Principle 796, decision no.251/1425 (2005)

⁸¹² Principle 320 decision 77/1423 (2003)

private enforcement and suggests ineffectiveness of statutory causes of action for the regulatory requirement of suitability, save in case where fraud is claimed. Consequently, it argues that both suitability and best execution will be enforced through traditional tort actions. Given that the CML was introduced on the basis of the US system, the study reviewed literatures which analyse how the suitability requirements has been employed in the American system. Following such literature review, it is illustrated that it is the agency theory which is most likely to suit the Saudi context.

E) Concluding Remarks

It has been pointed out that the CML framework is the first sophisticated system of regulation that has dealt with securities markets in the history of Saudi Arabia. The CML establishes a separate authority, the CMA, that is responsible for regulating securities markets, including the conduct of business. It is noted that the CMA enjoys extensive powers combined with lack of clarity as to the regulatory objective. On grounds that the ambiguity of regulatory objectives, lack of regulatory tools to assess the authority actions, and the CMA's right to extend the definition of securities, it is argued that the CML enjoys too many powers. It should be noted that, at one point, the government considered granting the CMA the power to amend the CML itself but sidestepped this.⁸¹³ Such a way of thinking is likely to reflect confusion on the part of the government between regulation and legislation and the difference in legitimacy between them. This also suggests a lack of understanding of the importance of the legitimacy of the sources of law and the rule of regulators in the general understanding of policymakers in Saudi Arabia.

⁸¹³ Beach (n 68) 326

It has been demonstrated also the important role that the CML regulatory framework ascribes to Tadawul, the formal exchange, in the institutional structure of securities markets. This was shown in the requirement, *inter alia*, of lodging a claim against a broker with Tadawul and its role as an SRO. However, the broad role of Tadawul diverges from international best practice. According to the World Bank, it is common for a regulator and an exchange enjoying monopoly powers to have mutual interests, especially in emerging markets, including the regulating of participants.⁸¹⁴ Nonetheless, the World Bank's recommendation is that if an exchange should retain self-regulatory responsibilities, 'it must establish a separate corporate entity with independent governance to administer them'.⁸¹⁵ In 2007 and in accordance with art.20 of the CML, the Council of Ministers approved the formation of the Saudi Stock Exchange Company (Tadawul).⁸¹⁶ Thus, Tadawul shares sooner or later will be listed. It is difficult to understand the reason why the draftsmen of the CML gave such an important role to Tadawul even though such approach is inconsistent with the best international practice. Beach and his colleagues may be excused of some responsibility since their attempts were to establish a new framework from the scratch and their intention was that the CML should be workable for a decade during which time an appropriate approach for the Saudi legal system would evolve.⁸¹⁷ There are many questions, however, which need to be answered. Is there a need to change the institutional structure once the exchange becomes a listed public company? Is there a need for a new law after a decade of implementation? How should conflicts and

⁸¹⁴ John Carson, 'Conflict of Interests in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them' (World Bank Research Working Paper, No. 3183, 2003) 15 <<http://ssrn.com/abstract=636602>> accessed 29 June 2011

⁸¹⁵ *Ibid*, 25

⁸¹⁶ <[http://www.tadawul.com.sa/wps/portal/!ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TlwMLj2AXA0_vQGNzY18Q1wAoH4kk7x4QZmrgaelTbBQc4GVs4GIEQHdwYpG-n0d-bqp-QW5EOQAsB49z/dl2/d1/L0IHskovd0RNQUprQUVnQSEhL1ICWncvZW4!/>](http://www.tadawul.com.sa/wps/portal/!ut/p/c1/04_SB8K8xLLM9MSSzPy8xBz9CP0os3g_A-ewIE8TlwMLj2AXA0_vQGNzY18Q1wAoH4kk7x4QZmrgaelTbBQc4GVs4GIEQHdwYpG-n0d-bqp-QW5EOQAsB49z/dl2/d1/L0IHskovd0RNQUprQUVnQSEhL1ICWncvZW4!/) accessed 29 June 2011

⁸¹⁷ 'The CML, however, was created with an idea of the kind of development necessary over the next decade for Saudi capital market to flourish', Beach (n 68) 320

tensions be solved once the CMA starts giving more consideration to competition policies in exchanges services?

This part has also demonstrated that private enforcement is recognised as a means for regulatory enforcement within the CML framework. It has listed the four statutory causes of actions provided within the CML itself, and argues that an investor still has a cause of action against a service provider in tort. Furthermore, it is pointed out that suitability could be based on a private cause of action in a similar way to those in the U.S., in theory at least. In such an event, the suitability requirement will be more likely to be on the basis of agency theory, which is compatible with the way the Saudi legal system considers relationships between agents in financial services and their clients. That brings different legal issues that must be dealt and is likely to be dealt with through litigation. For example, one of the questions before the CSDR is whether or not a financial adviser is bound by the regulatory requirement as an agent even though he or she is not a broker within the meaning of the CML. If the answer is in the affirmative, it has to be clarified how a customer is entitled to sue in tort for a breach of suitability according to general principles. Unfortunately, answering these questions is a matter of speculation, given the general tendency for courts and judicial tribunals in Saudi Arabia not to publish their decisions. A central recommendation of this thesis is that decisions made by the CRSD should be published which would help in determining the position of Saudi law and would allow the development of general theories for Saudi financial law.

It could be reasonably claimed from this discussion, similar to the UK, that private enforcement has been considered as an instrument in achieving policy objectives within the Saudi context. However, the two countries differ in how this instrument is implemented. Firstly, while the FSMA accommodates private

enforcement of a regulatory duty imposed by the FSA in a tort action, the CML provides only a cause of action with respect to fraudulent misrepresentation. Secondly, there is no restriction of the statutory cause of action *per se* to a particular type of investor within the CML regulatory framework. The FSMA, however, restricts any statutory action for a breach of regulatory rules to ‘private persons’. It is true that the two regulatory causes of actions are different both in nature and in their scope; s.150 of the FSMA is wider since it deals with tort and it is applicable to many regulatory duties, whereas the CML, in contrast, provides for a cause of action in case of fraud alone as far as suitability and best execution is concerned.

These differences between Saudi Arabia and the UK could be ascribed to the reliance on the American system of securities regulations, which influenced the CML through its draftsmen. It is a question, hence, of the desirability of each approach. It is argued that the American approach, which depends on a strong judicial institution, will bring the complexity identified within the American context into the Saudi legal context. Since in Part I it was claimed that there have been difficulties with the Shari’a as applied in Saudi Arabia in the development of securities markets, it is thus reasonable to maintain that bringing in complexity from the American system, which therefore would further increase the overall complexity, is undesirable. More appropriate is the UK approach which provides private enforcement through a tort action. Such approach enjoys a subtle advantage; it avoids the need for theoretical justification for the imposing regulatory duties in tort actions. Consequently, it is a recommendation of this thesis that an approach similar to the UK is adopted for the CML regulatory regime.

Part III Best Execution and Suitability

It is illustrated in Part II that the CML does not provide a cause of action for a breach of a regulatory rule but it is argued that an investor may have a cause of action in traditional tort against a financial service provider. Additionally it is suggested that the statutory cause of action provided by the CML deals mainly with fraudulent misrepresentation and thus would be beneficial for investors of fraudulent financial advice.

A traditional tort action therefore is the more important cause of action for any breach of a regulatory duty by a service provider. Such action will be based upon a failure on the part of a service provider to adhere to professional standards. That being the case, there is a need to determine what the level of standards imposed upon professionals is within the jurisdiction of the CML. The difficulty with this approach is the need to go through many provisions to identify what the CML regulatory framework imposes upon a service provider. Consequently, it is important to refer to different provisions of the CML and its Implementing Regulation, in order to identify a duty and its breach by a service provider.⁸¹⁸ The CML's framework imposes both suitability and best execution through the implementing regulations, namely the Conduct Market Regulation (henceforth CMR) and Authorised Persons Regulations (henceforth APR).

This part examines separately the regulatory duties of best execution and suitability as provided by the CML framework. However, before doing this, it is necessary to clarify the duty imposed upon service providers to classify their clients and its subsequent implication on the duties of best execution and suitability.

⁸¹⁸ The Implementing Regulations are accessible through the CMA's website at <http://www.cma.org.sa/En/Pages/Implementing_Regulations.aspx> accessed 29 June 2011

A) The Regulatory Requirement of Client Categorisation

Similarly to the COBS, APR requires authorised persons to categorise a client in one of three classes: a customer, an execution only customer, or a counterparty.⁸¹⁹ For the purpose of the APR, a counterparty is ‘a client who is an authorised person, an exempt person, an institution or a non-Saudi financial services firm’.⁸²⁰ A customer is defined as a client who is not a counterparty including an individual or legal person.⁸²¹ An execution only customer is defined as one ‘whom the authorised person only deals as agent in accordance with instructions provided by the customer and whom an authorised person does not advise’.⁸²²

For an execution only customer, it is clearly provided that an authorised person acts as an agent with specific instruction from the customer and must not provide an advice.⁸²³ It is unclear, however, throughout the provisions of the Implementing Regulations what the legal consequences are in case that an execution only customer receives a financial advice: whether he or she is entitled to the protection of ‘customer’ and hence entitled to be re-categorised, or the advice provided is not subject to the provisions governing financial advice including suitability.

The wording of the APR suggests that financial advice could be provided to counterparties and customers but not to an execution only customer. Given that part of the focus of this study is on retail investors receiving financial advice, it is

⁸¹⁹ APR Art.36 (a) and (b)

⁸²⁰ Ibid

⁸²¹ In ‘Glossary of Defined Terms Used in the Regulations and Rules of the Capital Market Authority’ available on the internet at <http://www.cma.org.sa/En/Pages/Implementing_Regulations.aspx> accessed 29 June 2011. Note that the Glossary refers to non-individual as ‘juristic person’ rather than legal person.

⁸²² Ibid

⁸²³ APR Art.36(c)

necessary to spell out how the CML regulatory regime provides additional protection for investors categorised as ‘customers’.

The APR imposes different duties on authorised persons dealing with investors categorised as ‘customers’, providing that they owe statutory fiduciary duties to their customers as follows.⁸²⁴ (1) the duty of loyalty, where authorised persons must act in good faith and in the interest of the customer; (2) the duty not to be involved in conflicts of interest unless this follows the procedure provided; and (3) authorised persons are not permitted to obtain secret profits from their relationships with customers. The latter prohibition includes acts in relation to property of customers, or relevant information or opportunities unless the authorised person obtains the customer’s consent pursuant to full disclosure of such usage. Finally, there is a duty to exercise care, appropriate skill and due diligence similar to those exercised by a person in similar circumstances having regards to the actual experience and knowledge that a person has, on the one hand, and, on the other hand, the knowledge and experience that may reasonably be expected of a person in the same position as the authorised person.

Given that statutory duties imposed upon service providers by the CML framework, it is therefore reasonable to claim that a service provider authorised by the CML holds regulatory fiduciary duties. The fiduciary duties imposed require a service provider, *inter alia*, to exercise reasonable care and due diligence taking into account what may reasonably be expected of a person in the same position as the authorised person. Considering that an authorised person is subject the Implementing Regulations, it could be argued that it is reasonable to expect the authorised person to

⁸²⁴ APR Art.40, and APR Annex 5.4 ‘Fiduciaries Duties’

be subject to suitability and best execution as imposed by the Implementing Regulations.

B) The Regulatory Requirement of Best Execution

It could be suggested that art.14 of the CMR is the main provision which deals with the regulatory duty of best execution, since in the English version of the CMR the provision is directly and clearly headed 'best execution'. It should be noted that the Arabic language is the main language used in Saudi Arabia and within the CML regulatory regime its terminology prevails. According to the Arabic version of CMR, best execution is introduced as *altenfeeth bea'afthal alshroot*. An exact translation of this phrase would mean 'execution in the best conditions', but reference to the English version clearly refers to 'best execution' and thus it is reasonable to maintain that it is ar.14 that imposes the duty of best execution in Saudi securities markets on authorised persons.

Article 14(a) of CMR states that 'where an authorised person deals with or for a client, it must provide best execution'. The CMR provides guidance as to how authorised persons can fulfil the best execution obligation, but differentiates between a broker acting as an agent and as a principal when dealing with a client.⁸²⁵ The CMR provides that where a broker acts as an agent, he must ensure that the order is executed at the best prevailing price in the relevant market or markets for the nature of the order.⁸²⁶ In contrast, where the service provider is acting as a principal, the broker must execute the transaction at a better price for the client than would have obtained if the order was executed in accordance with obligations imposed on a broker acting as an agent in a timely manner depending of the circumstances of

⁸²⁵ CMR Art.14(b)

⁸²⁶ CMR Art14 (b) 1

around the order.⁸²⁷ Since a better price is required in comparison with acting as an agent, it could be suggested that the CMR imposes a higher duty upon a broker who is a market dealer or is acting as a principal, in order to ensure that the sale price for a client does not exceed the price generally available in the market. Regardless of whether or not that would make difference in practice, it could be suggested that the CMR sets price as the priority in executing customers, which is similar to the concept of best execution provided in the COBS in the UK.

Having said that, there are differences between the CMR and COBS. Clearly, the CMR imposes additional requirements for execution in different provisions which, unlike the UK, are provided under the heading of best execution. For example, a customer's order has priority in execution over the broker's order.⁸²⁸ Furthermore, there are other subtle differences between the two regulatory regimes. In COBS, best execution is suggested to deal with the overall judgement of the broker in relation to the order of the client and, therefore, it includes provisions related to the timing, size and priority of the client's order. In contrast, the CMR provides the obligation of best execution focusing on the broker's judgement as to the market where the order is to be executed. The COBS approach is wider since it requires brokers to balance various factors in fulfilling the duty of best execution, whereas the CMR approach omits to mention considerations of timing and priority within the provision that deals with best execution. Whereas it can be argued that it is a difference in style rather than substances, it is possible to suggest, nevertheless, that the COBS and CMR envisage the regulatory duty of best execution slightly different.

In practice, it is unlikely that these differences between the COBS and CMR will result in dissimilar outcomes for investors, namely retail ones. Firstly, it is

⁸²⁷ CMR Art.13 and CMR Art14 (b) 2

⁸²⁸ CMR Art.12

scarcely conceivable that it would be possible to separate timing as an element from the duty of best execution duty, since price, timing and size are co-determining. This is clearly illustrated in the CMR where it imposes a requirement to execute a customer's order in a timely manner in a separate provision, but it re-states timing again under the provision for best execution. Secondly, the existence of a single exchange in Saudi Arabia renders secondary the importance of difficulties in fulfilling the duty of best execution. The discussion in the previous chapter relating to the UK experience suggests that the duty of best execution depends strongly on the context in which it is implemented, and it is argued that best execution and difficulties in fulfilling it are crucial in multi-exchange securities markets. This is illustrated within the UK context by showing that when the LSE was the only place to fulfil orders, best execution did not cause any concerns or create any problems. Therefore, given the important role of Tadawul in the institutional arrangement of CML framework for regulating securities markets, it is unlikely that the duty of best execution will raise any concerns, at least for the foreseeable future.

But it is unlikely that the concept of duty of best execution as it is is sustainable once a change occurs as to the status of Tadawul, the formal exchange. Changes within the CML framework could occur in one of two ways. Firstly, a decision by policymakers might change the institutional structure of the CML framework by reducing the role of Tadawul and promoting the establishment of other exchanges. Secondly, alternative means may develop for or by participants in securities markets to execute customers' orders. Given the reactive and *ad hoc* approach by policymakers, it is more likely that changes will occur as a result of the latter rather than the former. However, in both events, such a change would require a change in the implementation or the fulfilment of the regulatory duty of best

execution within the CML. Thus, this study hypothesises that, in the future, Saudi Arabia should take a similar approach to the UK where developments in securities markets led to developments in the regulatory duty.

As far as private enforcement is concerned, it could be argued that the duty of best execution as provided by the CML framework is simple and clear which makes it relatively simple to be incorporated in a traditional tort action against a broker in breach of it, for two reasons. Firstly, all brokers have to be licensed in order to provide brokerage services, otherwise the contract is unenforceable. Secondly, given that all services providers are licensed, they are subject to the CMA's powers including its Implementing Regulations. Hence, it could be concluded that all contracts reached with service providers will be subject to the regulatory duty of best execution as introduced by the CML regulatory framework. Accordingly, it could be claimed that, within the current context, the CML is effective in facilitating private causes of action in tort for breach of the duty of best execution.

However, similar to the criticism advanced to the UK regulatory regime, the CML does not provide a regulatory remedy to supply an incentive for enforcing the regulatory duty. The reliance on damages as the only remedy as well as the absence of systemic enforcement and a class-action regime would make it unlikely that retail investors will have the financial incentives to sue for breaching the regulatory duty of best execution.

C) The Regulatory Requirement of Suitability

While best execution is introduced by CMR, the regulatory duty is imposed through the APR.⁸²⁹ The Arabic version of APR refers to suitability as *Mula'amah*, which

⁸²⁹ APR Art. 1 states that '[t]he purpose of these Regulations is to regulate authorised persons and registered persons and to specify the procedures and conditions for obtaining a license, as well as the

means appropriate, adequate and proper, whereas the English version clearly refers to suitability. While it may be argued that there would be a difference between the *Mula'amah* and suitability, it is assumed that the meaning of *Mila'amah* is similar to suitability.

It is important to note that the APR deals with many obligations imposed on authorised persons in addition to conduct of business.⁸³⁰ Among these obligations provided are general principles 'intended to form a universal statement of the standards of conduct expected of authorised persons under these Regulations'.⁸³¹ Eleven principles relate to the recommended conduct of business affairs: 1. integrity, 2. skill, care and diligence, 3. management and control, 4. financial prudence, 5. market conduct, 6. customers' interests, 7. communications with clients, 8. conflicts of interest, 9. relationships of trust with customers, 10. clients' assets, and 11. relations with regulators.⁸³²

It is noted that under the FSMA regulatory regime, similar principles are provided by the authority, the FSA, and also pointed out that the English courts refuse to make them a basis for a statutory cause of action.⁸³³ Within the CML framework, however, these principles are likely to be incorporated within the judicial reasoning similar to the UK, but whether or not a breach of them is enough to result in a successful tort action without a breach of a provision in the implementing regulation is unclear. Such distinction in private enforcement is so vital given that the principles provided by the APR are of such similarity to those in the COBS which participants in

conditions for the maintenance of the license or the registration, to provide for the rules of conduct that authorised persons must comply with when conducting their business, as well as the rules and provisions governing the conduct of business'.

⁸³⁰ APR Art.5 (a)

⁸³¹ Ibid

⁸³² APR Art5(b)

⁸³³ Text to n 533 in ch 4

the UK have insisted that they alone cannot form a cause of action.⁸³⁴ Thus, it could be suggested additional clarification by the CMA of the role of these principles in the APR in a tort action by investors is important for the certainty of the regulatory regime.

While the position is unclear under the CML framework as to the right for investors to sue in tort for a breach of suitability on the basis of a principle in the APR, it is likely that the suitability ‘principle’ would be of little benefit for an investor. As far as the regulatory duty of suitability is concerned, the APR provides that an authorised person must take ‘reasonable care to ensure the suitability of its advice and discretionary managing decisions for any customer to whom it provides those services’.⁸³⁵ If that is the case, it could be suggested that this duty under the CML regulatory regime requires the financial adviser to make sure that reasonable care is taken in giving suitable advice. It could therefore be argued that a customer willing to sue has to prove to the court that the service provider allegedly in breach failed to take reasonable care in providing the unsuitable advice. In such a case, it is likely that a customer would be better advised and in an easier position to a claim for a breach of other suitability provisions rather than a claim of the unsuitability of the advice provided mere on the suitability principle, since then it would be more specific, easier to identify, and easier to establish a breach. Therefore, it could be expected that the suitability principle may be inadequate on its own to form the basis for a tort action. The provision headed ‘suitability’ in the APR provides additional guidance to the suitability duty. According to the APR, authorised persons must not deal, advise or manage for a customer or take collateral for their own account from a customer, unless the advice given or transaction made is suitable for

⁸³⁴ Because of its generality, participants in the UK insisted that the principles must not form a basis for statutory action, Ibid

⁸³⁵ APR Art.5(b) 11

that customer.⁸³⁶ Such a wording is ambiguous since it may suggest a meaning that an authorised person should not make a transaction which is unsuitable for the customer. Effectively, that would extend the duty imposed on authorised person to ensure the suitability of transactions made by the customer. English courts have been cautious not to extend such duty under English law,⁸³⁷ and further clarification by the CMA should be provided.

It seems that the CMLA regulatory regime has a wider application for the suitability in comparison to the FSMA regime. For instance, an authorised person is prohibited even from advertising a ‘non-retail’ investment fund or a securities derivative unless it has been determined that they are suitable for the customer.⁸³⁸

As far as the requirements of the duty are concerned, the APR states that suitability should be determined by authorised persons on the basis of facts disclosed by the customer and other relevant facts of which ‘the authorised person is, or reasonably should be, aware’.⁸³⁹ The APR provides the minimum amount of information that an adviser should be aware of by stating that authorised persons attempting to fulfil the duty of suitability should have regards to: (1) the customer’s knowledge and understanding of the relevant securities and markets, and of the risks involved; (2) the customer’s financial standing, including an assessment of his net worth or of the value of his portfolio based on the information disclosed by that customer; (3) the length of time the customer has been active in the relevant markets, the frequency of business and the extent to which he relies on the advice of the authorised person; (4) the size and nature of transactions that have been undertaken

⁸³⁶ APR Art.43(a)

⁸³⁷ For example, see *JP Morgan Bank (formerly Chase Manhattan Bank) v Springwell Navigation Corp* [2008] EWHC 1186 (Comm)

⁸³⁸ APR Art.35

⁸³⁹ Ibid

for the customer in the relevant markets; and (5) the customer's investment objectives.

Given that these requirements are lists of factors that the APR states that an adviser should have regards to, it could be suggested they are the least required factors that a reasonable authorized person should be aware of. However, in the event that an adviser has obtained only some of this information, the APR is silent on whether the adviser is permitted to assess suitability on the basis of the available information, or if he should refrain from providing any advice at all. The impact of the difference on private enforcement is significant. In the case of the latter approach, if a service neglects to take into account one of these factors and subsequently provided an unsuitable advice that resulted in a loss, it could be argued that a customer may have a case against the service provider. Therefore, it could be suggested that the CML regulatory regime facilitates private enforcement by providing the factors that a financial adviser should take into account. However, if the former approach is preferred, the court should assess first whether or not the advice provided was suitable considering the available information with reference to the standards of the industry. Thus, there is a limit of uncertainty as to this approach that may hinder private enforcement.

The previous paragraphs demonstrate the position of the CML's regulatory framework as far as the regulatory requirement of suitability is concerned. Nevertheless, several points are worth mentioning.

Firstly, the provisions of APR restrict the applicability of suitability to authorised persons dealing with customers only. Effectively, this excludes from its scope those who provide financial advice but are not considered to be brokers for the application of the CML. Moreover, it is unclear what the position is under Saudi legal

framework with regards to imposing these requirements upon non-authorised persons who are not brokers. It is pointed out in Part II that the easiest application for imposing such duties is the ‘shingle theory’, but it is argued that it is unlikely that this theory could fit within the Saudi context. Additionally, since a mere financial adviser does not need authorisation, it is difficult to suppose that regulatory fiduciary duties can be imposed upon such a person given that, firstly, the adviser is not authorised and hence is not obliged to categorise clients, and, secondly, ambiguity exists with regards to general law in this case since there is no code for tort, contracts or obligations, nor are there general principles in Shari’a as applied in Saudi Arabia on the subject.⁸⁴⁰ Thus, if a non-broker unauthorised person has provided unsuitable financial advice, it is doubtful that the CSDR would hold him directly liable for failing to take reasonable care in accordance with the CMA.

Secondly, while the APR prohibits the provision of financial advice to an execution only customer, the CML regime does not clearly spell out what financial advice is. It has been suggested that, in modern markets, it is very difficult to determine the boundary between a selling process and that of financial advice; this was a grey area exploited by participants for which the concept of suitability was developed in the U.S.⁸⁴¹ The main provision that determines what constitutes financial advice is art. 1 of the CML, which refers to investment advice as given by someone who:

‘... provides, offers or agrees to provide, advice to others in their capacity as investors or potential investors, in relation to purchasing, selling, subscribing or underwriting a security, or

⁸⁴⁰ Further discussion in this chapter Part I a, b, c and e

⁸⁴¹ Text to n 397 and 308 in ch 3

exercising any right conferred by a security to acquire, dispose of, underwrite or convert a security'.⁸⁴²

Given that there is no further clarification on the matter by the CMA or the Implementing Regulations, it could be argued that a clear breach of suitability by an authorised person exists when that authorised person is advising on a security; but there is no clarity in this area in the CML framework as to what the meaning of advice is. Is advice to a customer ever subject to suitability even in a sales process? Is an authorised person obliged by the suitability rule although it is clear from the context that it is not expected that a customer would rely on such an advice? These questions and others are left open to judicial discretion to deal with.

Thirdly, if, according to the CML's definition of 'investment advice', suitability is restricted to securities, there are two categories of financial advice which are not included with it: firstly, unauthorised persons who are not brokers but are recommending a security, as discussed above; and, secondly, authorised persons recommending non-securities financial products such as insurance. The former create difficulty as to how to impose the duty of suitability on this class of financial advisers, whereas the latter excludes authorised service providers from the regulatory duty of suitability because they are not advising on securities. This is not necessarily problematic *per se*, but it fails to deal with the reality of both financial markets in Saudi Arabia and the financial products themselves.

The current institutional structure adopted in Saudi financial markets is the separation of its sector by providing separate regulatory authorities, separate regulatory frameworks and separate judicial tribunals for each sector of banking, securities and insurance. The reality of the Saudi markets is represented in the fact

⁸⁴² CML Art1

that banks have been permitted to engage in securities and insurance markets provided that they establish subsidiaries in each sector. Thus, it is not unreasonable to expect some level of co-ordination in promotion or cross-selling of financial products among those entities. By restricting investment advice to securities, an authorised person within the CML framework might be tempted to provide unsuitable advice for non-securities products.

Moreover, by restricting investment advice on securities, the CML approach does not take into account the complexity of modern financial products that cut across the three financial sectors. Accordingly, the principal question is whether jurisdiction over this product is subject to the CML, banking or to the insurance authority? Given that there is no institutionalised system to deal with such conflicts, it is likely that confusion and overlapping jurisdictions would be likely to exist.

Finally, it should be noted that the concept of suitability in the ARP is different from those in the UK and the US, in principle because it fails to recognise quantitative suitability at all. The requirement to consider the frequency of trade is provided by the CMR rather than the APR. Oddly, given the influence of American thought in drafting the CML, there is no distinct differentiation in the APR between ‘customer-basis’ suitability and ‘reasonable-basis’ suitability as developed in the US.⁸⁴³

In short, the regulatory requirement of suitability is imposed on authorised services providers by the CML regulatory regime but there are some shortcomings. Similarly to the COBS, the APR does not detail exactly when a financial advice is provided or how to differentiate between the sales process and a recommendation. It is also argued that the benefit of suitability is restricted for two reasons: firstly,

⁸⁴³ For more information as to the difference, the American approach and the UK approach, reference is made to text to n 366 in ch 4

because the APR is imposed upon authorised persons only; and secondly, due to the restriction of the CML itself of investment advice to recommendations related to securities. It is suggested that this approach in the CML fails to take into account the political economy of the financial markets in Saudi Arabia and the complexity of modern financial products.

Part IV Concluding Remarks

This chapter has attempted to evaluate whether or not the current regulatory regime in Saudi Arabia ensures that the duties of both suitability and best execution are implemented in such a way that facilitates private enforcement by retail investors. It is illustrated that, as regulatory requirements, both suitability and best execution are imposed on service providers through the rule-making power of the CMA exemplified in the Implementing Regulations.

The historical analysis of Saudi financial law shows that different policy decisions have been implemented by the CML, including the establishment of a special judiciary system for the securities market in Saudi Arabia. However, it is argued that this approach does not solve underlying issues of financial law and regulation in Saudi Arabia such as the incompatibility of modern financial practices with Shari'a principles. It is argued that failure to deal with these issues increases uncertainty, hinders market development and raises questions of legitimacy with regards to the rule of law. Such difficulties in Saudi Arabia are clear examples of how failures to solve theoretical questions have several practical implications. In contrast, the UK did not have such underlying problems at the time of the introduction of the FS regime, and English courts have dealt with financial and securities markets

disputes for years, if not centuries. This suggests that these countries differ in the efficiency of their court systems as well as their jurisprudence at the time of the introduction of their initial regulatory regime. Whereas in the UK the enjoyed a wider role with higher level of efficiency as well as clarity as to jurisprudence, Saudi Arabia started from a lower level of efficiency, the courts' refusal to deal with financial claims, and uncertainty of jurisprudence.

With similarity to the FSMA in the UK, it is pointed out that private enforcement is part of the CML regulatory regime in Saudi Arabia. The instrument used in CML is to provide a statutory cause of action for specific breaches, including against fraudulent misrepresentation. The positive side of this cause of action is that it is not restricted to a class of investors, being available to all investors against not only licensed brokers but extended to unauthorised persons as well. It is argued that it is possible, in theory, that a private enforcement of suitability and best execution could be based on this right of action, which would be similar to Rule-10(b) in the U.S. There are, however, two negative issues as far as this study is concerned. Firstly, it is noted how American jurisprudence provides different justifications which hold services providers to their regulatory duties in the absence of fraud; and, secondly, the private enforcement of suitability through the anti-fraud provision is unlikely to be easy to establish by retail investors given the high requirements of materiality and reliance on fraud which need to be proven for an action to be successful. Accordingly, it is argued that the CML's approach with regards to the statutory instrument chosen for providing private enforcement is too narrow in its usefulness in enforcing either suitability or best execution.

Having said that, this study argues that a retail investor might have a cause of action in tort against a service provider who is in breach of the suitability or best

execution regulatory requirements. For a successful tort action within the Saudi financial context, a retail investor must show that there was a breach by the defendant, the plaintiff suffered damage, and there was a relationship between the breach and the damage. There is a lack of clarity concerning how the duties imposed by the regulatory regime could be useful for a tort action in Saudi Arabia, however, which renders it difficult to facilitate a cause of action by retail investors. This, accordingly, contradicts the argument provided in chapter two that an effective enforcement regime including private action should take into account the difficulties that face retail investors.

Both the provision of a direct right of action as well as ambiguity as to traditional tort actions make the likelihood of an effective private cause of action for the regulations very questionable. Any argument based on actions similar to Rule10(b) in the U.S. is unconvincing; since such a framework requires an effective, reliable judiciary as well as clarity of the substantive law as to the relationship between regulatory duties and traditional tort law, both of which are lacking in Saudi Arabia. In contrast, the U.K. institutional design is more direct and provides clarity. It leaves to the authority, and not courts, the task of identifying those duties which could be privately imposed. The UK approach permits an uncomplicated, coherent and explicit example of how to accommodate regulatory duties within established and existing private law institutions. On balance, the UK approach is more favourable since it is a simpler process and relies more on the regulatory authority rather than the courts.

Subsequently, the analysis focused on the provisions relating to both suitability and best execution, with a view to evaluating how these provisions could facilitate retail investor action in tort. The discussion above in relation to suitability

indicates that the APR framework adopts a concept of suitability which is different from those in either the UK and the US. In theory, the APR does not impose 'reasonable basis suitability' or a requirement to conduct an assessment of quantitative suitability. In practice, it is argued that the wording of the CML and APR themselves results in the restriction of suitability to recommendations provided by licensed brokers.

However, it noted that there are negative impacts of this approach by the CML framework, since it increases uncertainty. The CML regulatory regime fails not only in providing guidance as to when a recommendation is in fact 'investment advice' for the purposes of the CML regime, but also does not take into account the modern complexity in structure of financial products that cut across the boundaries of financial sectors. These issues, combined with the systemic avoidance of the publication of judgements and awards, is argued to increase uncertainty for both investors and service providers as to the position of Saudi law and how the CSDR would treat these rules.

Accordingly, it could be argued that, as implemented by the CML, the regulatory regime of private enforcement of the regulatory duty of suitability is ineffective.

Furthermore, it is noted that, under the CML regulatory regime, the best execution rule is clear and detailed and suitable for the current Saudi context. The fact that there is only one exchange in Saudi Arabia renders the application of the best execution regulatory rule a straightforward task. However, it is likely that best execution will be more important and create difficulties once the Saudi securities market starts to evolve towards a multi-exchange system. Such a development may require a new regulatory framework, since it is argued that the current institutional

framework is not in line with best practice for the development of multi-exchanges markets. It is also noted that the CML regulatory regime does not provide a systemic or collective mode of private actions or remedies that would be important in overcoming difficulties identified with the private enforcement of the best execution rule.

As to the substantive duties, the analysis indicates there are similarities as to the drawbacks in both the U.K. and Saudi Arabia. As far as suitability is concerned, both regulatory regimes fail to provide a clear and simple way to both measure and comply with the regulatory duty of suitability. However, it could be suggested that, in both case studies, the duty of suitability imposed requires an adviser to recommend a suitable investment rather than the most suitable one. The reason provided for lack of detailed provision for suitability in theory is that it depends on the context and circumstances of each case, and this could explain the lack of clarity. However, this very same reason supports arguments for an increased role for private enforcement, given that private parties are better suited to detect violations.⁸⁴⁴

In contrast, the regulatory duty of ‘best execution’ in both countries is more straightforward in comparison to suitability. While many factors have been provided by the regulatory regime in determining how to comply, an emphasis on the price in dealing with retail investors is arguably the reason for such clarity. The analysis suggests that the weight ascribed by the regulatory regimes to price helps retail investors in bringing private actions because, firstly, it is easier to identify a breach, and, secondly, it shifts the burden of evidence to the service provider (i.e. the broker). The service provider thus has to demonstrate why compliance with duty requires disregarding the best available price in a specific case. With these advantages in mind,

⁸⁴⁴ See ch 2 Part II

the analysis of regulatory regimes in both countries reveals that retail investors attempting to enforce best execution lack incentives in pursuing such an action because of the insignificant rewards compared to the costs of pursuing action. In both countries, it is argued that it is the absence of remedies which provide additional incentives that render private enforcement ineffective.

The similarity between both countries with regard to the substantive obligation suggests that there is a subtle link between the substantive obligations imposed by the regulatory duties themselves and the role of private enforcement. Taking best execution as an example, it is the focus of both regulatory regimes on price that makes private enforcement less burdensome for retail investors. In contrast, suitability as a regulatory duty depends strongly on the context in which is applied. Therefore, as far as substantive obligations are concerned, it could be advanced that regulatory duties imposed for the benefits of retail investors require clarity as to how a breach of the obligations could be detected.

Such clarity is likely to differ from one regulatory duty to another. Experience and knowledge of the particular regulatory problem can help in identifying what the important factors are for retail investors, which could be incorporated subsequently into the regulatory obligations. This, however, take us back to arguments advanced in chapter two that the effective private enforcement of securities markets regulations involves considerations of, *inter alia*, the regulatory problems as well as the characteristics of retail investors.⁸⁴⁵

Following our analysis, it is a question of how to design a private enforcement framework for securities regulations within a regulatory regime which can effectively

⁸⁴⁵ See ch 2 Part II

encompass private enforcement. The next chapter provide a paradigm for an optimal design following the summary and main findings of this thesis.

Chapter Five

The Conclusion

Summary

The main objectives of this thesis are twofold: firstly, to emphasise the importance of enforcement in general and private enforcement in particular for compliance with secondary securities market regulations; and, secondly, to explore how a regulatory regime may increase or decrease the role of private enforcement through not only making available to investors causes of action grounded in breach of regulatory obligations, but also provisions delimiting substantive obligations. To these ends, the analysis contained in this thesis has shown how effective the implementation of the regulatory doctrines of ‘best execution’ and ‘suitability’ within the regulatory regimes of national securities markets have been.

The UK and Saudi Arabia have both incorporated elements of private enforcement into the overall enforcement of their regulatory rules, which is in line with the broad theme of this thesis and its argument as to the importance ascribed to private enforcement within the regulatory regimes. In both jurisdictions, the legal, political and economic environments that existed when securities markets laws were first introduced determined the instruments used in facilitating private enforcement as well as the manner in which the two regulatory requirements of suitability and best execution were introduced by current regulatory regimes. The principal finding is that the two countries have differed as to the design of the regulatory private enforcement within their regulatory regimes.

As a necessary part of the main argument of this study, therefore, chapter two has presented a theoretical background concerning the importance of securities markets in general and secondary securities markets in particular as well as the need to regulate them. Chapter two thus discussed secondary securities markets under fully developed systems of regulation, and started by defining the difference between primary and secondary securities markets as well as the important role of financial services intermediaries, focusing on stockbrokers in particular, within the existing structure of the overall benefits sought from securities with specific attention to secondary securities markets. Subsequently, this chapter illustrated the importance of legal actions of private actors in enforcing securities markets regulations and concluded that, given our current knowledge of secondary securities markets and the available empirical data, private means of enforcement cannot be fully replaced by public enforcement. It was also suggested that available explanations as to how law affects economic growth are weak once they are applied to secondary securities markets, and that the empirical data available point in different directions. Accordingly, it was suggested that no connection between trading rules and corporate law can explain differences in the performance of secondary securities markets in two different legal jurisdictions. Such a claim is significant since, as a source of legal differences among legal families, corporate law has been dominant in explanations of differences between legal systems. Consequently, because of the absence of an optimal framework, the chapter hypothesised that, in terms of the role of private enforcement within regulatory regimes, countries will differ in the design of their regulatory protection. Given the absence of an existing optimal framework, the chapter demonstrates that, on the basis of the literature as to private enforcement of public law, a framework for retail investors in securities markets regulations should

take into account the characteristics of these investors concerning enforcement, namely the lack of incentives, the ambiguity of law and their lack of awareness of their rights. A framework should also take into account the regulatory problems that private enforcement is aimed at correcting or overcoming. Contextualising these regulatory issues by focusing on suitability and best execution, this chapter points out the importance of suitability and best execution, as regulatory duties, not only to ensure investors confidence, but also the appropriate allocation of resources.

Chapter three presented an evaluation of the UK securities regulatory regime and discussed private enforcement with a particular focus on suitability and best execution. The chapter gave a brief overview of the historical development of regulatory frameworks for securities markets, as well as how the regulatory concepts of both suitability and best execution evolved within the UK context. The chapter showed that the two duties have been implemented within the FSMA regulatory regime and explained how investors are permitted to privately enforce the two rules. The chapter demonstrated that both of these regulatory rules have been introduced through the COBS, and their private enforcement is permitted through a cause of action in tort for a breach of statutory duty in accordance with s.150 of the FSMA. It was shown that this approach to private enforcement by the FSMA increases certainty and predictability and therefore is more able to enhance the functioning of securities markets. Set against these advantages of the instrument used to provide private enforcement, some shortcomings were identified. Firstly, even though the instrument has been subject to criticism as to its effectiveness in the previous regulatory regime on the grounds that it was restricted to those who might not have the financial means to exercise it, it was subsequently re-introduced into the current regulatory regime without any change. Secondly, the instrument necessitates the actionability of the rule

to invoke it and it was demonstrated that the FSA was granted the power to determine the actionability of rules in COBS. It was argued that the FSA's decision to restrict the main regulatory protection to 'retail clients' has subtly reduced the scope of the instrument and hence limited its effectiveness. Finally, it was claimed that the effectiveness of the instrument used for private enforcement is affected by the clarity in and the details of the regulatory rules concerning the substantive obligations and duties. A lack of clarity was demonstrated concerning the issue of what constitutes a personal recommendation from the perspective of COBS, and it is unclear how wide the scope of the duty of advisers actually is. In addition to the absence of a means to assess how to fulfill the requirement of suitability, the conclusion was drawn that these factors increase uncertainty about the duty imposed. Consequently, it was argued that the increase in uncertainty associated with the rule has had a negative impact on private enforcement. It was shown that the best execution rule introduced by the COBS does indeed provide a fair degree of the detail necessary to facilitate private investment. Reference to the historical development of the regulatory rule itself, however, draws attention to the absence of an effective class action system within the UK as well as the non-recognition of punitive damages as an available remedy. The effectiveness of the private enforcement of the regulatory rule of best execution is therefore limited. Overall, there is a room for substantial improvement in the effectiveness of the private enforcement of regulatory rules within the FSMA regime.

Chapter four then evaluated Saudi securities law, regulations and judicial practice. The chapter examined public policy in Saudi Arabia, the importance of the Shari'a as a source of law, and the application and effects of the school of thought of Shari'a as applied in Saudi Arabia, which has proved to be problematic in various

ways due to its nature being fundamentally different from those in current Western legal systems. The chapter included some important examples of the interpretation of Shari'a as applied in Saudi Arabia, since this is the main source of law, in creating various difficulties for modern securities markets. This part of the chapter showed that there are serious questions of legitimacy and the rule of law in Saudi Arabia which not only problematise some current practices but will also hinder the development of securities markets. The chapter then examined the provisions of the CML and the Implementing Regulations introduced by the CMA with reference to available relevant published case law in Saudi Arabia, in order to examine issues related to the private enforcement of suitability and best execution. This section started by assessing how best execution and suitability are privately enforced within the CML regulatory regime. It was demonstrated that there are novel statutory causes of action introduced in the CML, but as far as the inquiry in the present study is concerned, these are limited to fraudulent activities, which require a higher burden of proof. Hence, it was demonstrated that requirements of suitability and best execution in the event of breach are more likely to be privately enforced through traditional tort actions as developed by previous judicial tribunals. The chapter then examined how the regulatory requirements of suitability and best execution were introduced through the Implementing Regulations. It was shown that, although the duty of best execution is detailed enough to suit the present situation that prevails in Saudi Arabia of a single exchange in which securities trading takes place, a lack of incentives will undermine private enforcement of the rule once the Saudi market is capable of developing a multi-exchange system. As far as the regulatory duty of suitability of investment advice is concerned, it is shown that the regulatory regime is silent on how to differentiate between a sale process and a mere recommendation. In addition, the

CML regime fails to take into account the political economy of the securities markets in Saudi Arabia and the complexity of modern financial products when restricting the imposition of suitability to authorized persons advising on securities. This generates many questions that need to be addressed for the practical application of the rule so as to increase certainty, predictability and investor protection. Moreover, the fact that judicial decisions are not published in Saudi Arabia contributes to the persistence of uncertainty among both the general public and prospective foreign investors, given that practitioners may only obtain answers to such questions through their own litigation and not through recourse to any settled, clear and accessible legal principles. These issues of uncertainty are in direct conflict with both the importance of certainty and clarity of the law for efficient securities markets and the Saudi public policy of attracting foreign investment for the purpose of job creation and economic growth.

Throughout the discussion in chapter four, the analysis compared the treatment of suitability and best execution in financial intermediation under the Saudi regulatory regime with that in the UK. It was seen that the Saudi approach is not as effective as that in the UK in providing for or increasing certainty about the private enforcement of suitability and best execution. Whereas the U.K. provides a more appropriate institutional design for the private enforcement of regulations, the Saudi regime, which has been built on a way similar to that in U.S, relies on the courts to a large extent. Notwithstanding the differences in design for the private enforcement of securities markets regulations, it is pointed out that both countries are similar in other respects. The two countries provide less clarity as to how to comply, and subsequently detect violation, with the regulatory duty of suitability, whereas more clarity is available for the best execution duty. The two countries' regulatory regimes are restrained from providing incentives for retail private investors for the enforcement of

best execution, where the costs involved are greater than the rewards or the benefits sought after by retail investors.

Main Findings

This thesis has derived findings of considerable interest from the comparative methodology adopted. A comparison of the two case studies reveals significant differences. The two countries have adopted different approaches to the institutional structure of their regulatory frameworks for securities markets. The UK developed a unified regulator responsible for the conduct of the business of practitioners in all financial sectors, whereas Saudi Arabia chose a separate regulator for each financial sector and confined to the CMA responsibility for securities markets. It is not within the remit of this thesis to examine the reasons behind these differences or the appropriateness of each type of institutional structure but, nevertheless, it must be pointed out that one difficulty identified in the Saudi approach is the existence of regulatory arbitrage created by modern financial products.

Perhaps surprisingly, notwithstanding these substantive differences, there are a number of similarities between the UK and Saudi Arabia.

Firstly, the two countries introduced regulatory frameworks for securities markets for the first time in attempting to implement policy decisions which would change their social and economic structures. Accordingly, the two countries provide examples of the use of law as an instrument in achieving economic policy.

Secondly, both countries impose the two duties on service providers in their countries not through primary legislation but via regulations introduced by the authorities responsible for regulating securities markets. Consequently, differences of perception among regulators concerning what a regulatory duty entails would affect

the implementation of the concept. This is proven by the fact that the two countries have developed their own perceptions of what suitability and best execution entail, and these are different from those currently predominant in the US where both duties originally developed.

Thirdly, both countries have incorporated private enforcement within their regulatory regime by providing a cause of action. Support for private enforcement is reflected in the introduction of statutory causes of action arising from a breach of the statutory framework. As far as this thesis is concerned, the FSMA directly permits private enforcement through a tort action for a breach of a statutory duty; whereas the CML relies on a less effective statutory cause of action in cases of fraud.

Finally, although the two countries associate the imposition of the duty of suitability with the provision of a recommendation, there is no clarity in practice in their regulatory regimes as to when a recommendation will be subject to the regulatory duties imposed to ensure its quality, including suitability. This creates further legal issues. For instance, the development of technology in communications and computer programming gives service providers the ability to provide their customers with automated financial advice online.⁸⁴⁶ Legal questions arising from such innovations include whether or not there is a need to ensure the quality of automated advice over the Internet using regulation. If the answer to this question is in the affirmative, a question arises as to the responsibilities of both investors and service providers concerning inappropriate advice in contrast to conventional means of providing financial advice or recommendation. The clarity of regulatory duties is important not only for private enforcement, but also for service providers in order for them to comply with regulatory requirements efficiently and at low cost.

⁸⁴⁶ On this subject see, for example, Dimity Smith, 'Financial Services Regulation and The Investor as Consumer' in Geraint Howell and others (eds), *Handbook on Research on International Consumer Law* (Edward Elgar 2010) 475-476

The thesis posed several questions in the introductory chapters which have been dealt with in the thesis thoroughly and promptly. It is thought appropriate to briefly provide answers in this conclusion chapter and to leave the reader with a sense of the relevant arguments and findings.

The main question of the thesis is whether or not regulatory duties, introduced on the basis of investor protection supported by private causes of action in secondary securities markets by retail investors, are effective to ensure the appropriate behavioural standards in these markets. The thesis has shown that, in both case studies, notwithstanding the recognition of the role of private enforcement, its effectiveness is questionable in practice due to the instruments chosen. In the UK, few cases have been brought based on s.150, while express provisions are made by the FSMA to permit investors to enforce a breach of a regulatory rule and seek damages. From the analysis of private enforcement in the UK, it is maintained that s.150 as it stands now might be unsuitable for the UK context; the fact that many complaints are brought before the FOS but are rejected on grounds of compensation limit indicates that there is a potential for private enforcement alongside public enforcement at best, or to make up for the lack of public enforcement at worst. The argument put forward here is that, even though the FOS was meant to increase access to justice rather than a means for private enforcement, it may be the only efficient and effective method available to retail investors.⁸⁴⁷

On the other hand, the lack of a case reporting system in Saudi Arabia makes it impossible to conclude with certainty as to the lack of effectiveness of the chosen instruments provided by the regulatory regime for private enforcement. However, the analysis in this thesis points out that the scope of the regulatory mechanism for

⁸⁴⁷ Such a claim supports MacNeil's description of s.150 as a 'dead letter' in MacNeil, 'The Evolution of Regulatory Enforcement Action in the UK Capital Markets: A Case of 'Less is More'? (n 579) 362

private enforcement chosen by the regulatory regime is limited to breaches which involve fraud. Relying on courts to develop a right of action similar to the situation in the U.S. requires an independent, strong and trusted judiciary, which is absent in Saudi Arabia. Thus, it is argued that it is more plausible that suitability and best execution would be more effectively enforced privately through traditional tort actions.

Accordingly, it could be claimed that in both case studies the chosen regulatory instruments for the private enforcement by retail investors of applicable behavioural standards are ineffective. Detailed analysis of the factors that have influenced the effectiveness of the instruments as well as suggestions for increasing their efficiency have been summarised in the conclusions of each separate case study.

The current thesis posed several sub-questions in the introductory chapter that are worth detailing here.

The first involves whether or not policymakers should be concerned with the regulation of securities markets in general, and secondary securities markets in particular.

It was noted that there are compelling arguments showing the impact of the law concerning securities markets in reducing the costs of finance and improving the process of the allocation of resources. Secondary securities markets are of considerable importance since they increase trust in the primary markets as well as increasing the provision of credit and reducing the costs of finance. Given the impact of efficiency in securities markets on the broader economy, there is a social welfare consideration in maintaining their functioning. However, these markets depend on trust and information and, in the absence of regulations, informational disadvantages as well as opportunistic behaviour that decrease the integrity of these markets will

persist. Regulations, therefore, are needed to maintain the investors' trust as well as ensuring a level of fair play between investors, issuers and other participants.

A second sub-question posed in the thesis asked whether or not the pursuit by the state of investor protection using specific laws, through the provision of regulatory obligations and remedies in secondary securities markets, is a desirable legal objective to justify the substitution of traditional principles of law.

Scholars have pointed that out spontaneous developments in traditional law are rarely adequate in financial markets in general for two reasons: firstly, the improvement of financial market law requires simultaneous changes in different legal rules,⁸⁴⁸ and, secondly, spontaneous developments in traditional law take far longer than the time limits imposed by a country's specific challenges, such as the present need for privatisation or implementing a market orientation programme. Thus, it could be suggested that the natural evolution of traditional law is unsuitable in providing the needed substantive protection promptly.

As far as private enforcement is concerned, it is pointed out that traditional legal mechanisms are unlikely to be adequate; firstly, there are several problems with enforcement within the realm of retail investors in particular; and secondly, regulations introduced by a state are necessary to maintain investor confidence in times of crisis. It is possible that traditional legal mechanisms may or may not introduce such duties after a long period of litigations. But the urgent need to reassure investors can not be provided by traditional mechanisms within the time available.

Furthermore, the analysis in this thesis identifies three broad categories of justifications for regulations introduced by states on the basis of investor protection in securities markets, and financial markets in general: economic, moral and political. It

⁸⁴⁸ See Black (n 3)

was demonstrated that none of these justifications is sufficient on its own to justify every action taken by a state in securities markets, but, nonetheless, they provide the principal justifications for state intervention based on investor protection.

The economic explanations state that deterring malpractice is not an objective of securities regulations or state intervention *per se*; state ‘intervention’ seems likely to reduce the unnecessary misuse of resources as a result of the unwillingness of investors to invest or participate in financial markets. In other words, it is all about increasing the efficiency of securities markets; hence if markets are efficient there are no grounds for a state to intervene. Morality as a ground was suggested to be too broad to constitute a universally applicable explanation irrespective of context or the moral values of societies. Political theory was argued to limit state intervention to political motivations or threats of instability; it was proposed that if there is no risk to the political system, there is no need for the state to intervene. However, the literature on political motivations for state intervention suggests that a state could intervene, notwithstanding the nonexistence of any threat to political stability, moral duty or economic efficiency.

In short, traditional legal mechanisms and institutions are not appropriate for the protection of investors. There are many compelling arguments justifying state involvement to protect investors, which can be broadly categorised as economic, moral and political.

A third sub-question concerns what the effects are of the importation of legal rules and principles that have characteristics foreign to a national legal system, especially in the case of the regulation of secondary securities markets.

Initially, the thesis attempted to review the relevant literature to identify the types of law important for secondary securities markets and which are capable of

generating economic growth. The thorough discussion in chapter three demonstrated that there is still disagreement among scholars as to what types of legal rules are important for well-functioning secondary securities markets in general, and capital markets in particular. However, the list was narrowed to three areas of law: (1) corporate law; (2) securities law; and (3) trading law.

While it was argued that none of these three areas alone is capable of satisfying the needs of the different relationships identified in secondary securities markets, it was pointed out that the shares of many companies are able to enjoy a high level of liquidity and trading, which are factors considered to represent success, even though they are listed in legal systems that have different legal characteristics of corporate law from those in their home countries. Accordingly, it was suggested that, as far as the law of trading as an activity is concerned, there is a weak connection between trading rules and corporate law. Corporate law matters since it is often argued that convergence between systems based on common or civil law is unlikely because of irreconcilable theoretical differences between them as to corporate law.

Given that trading rules are weakly connected to corporate law, it follows that they are able to be borrowed and transplanted without any difficulties or negative impact on predictability and certainty.

In contextualising the theory in the present case studies, the thesis has shown that both regulatory duties of 'suitability' and 'best execution' were developed in the US and were transplanted to the UK and Saudi Arabia, and, hence, it is argued that both duties are foreign to the national legal systems of the case studies in the thesis. However, it was shown that there are substantive differences between the existing regulatory rules in the case studies from those in the country from which they were transplanted, namely the US. Interestingly, while the present thesis identified

differences between the traditional law and regulatory rules in the UK, no such legal pluralism has been identified. In fact, the substantive content and entitlements provided by the regulatory rules have prevailed.⁸⁴⁹ It was not possible to examine whether or not the same is happening in Saudi Arabia due to the lack of a case reporting system. Despite this, it was speculated that such a legal pluralism would exist due to the separation in the judicial system in Saudi Arabia of securities disputes from general law rather from the introduction of the duties themselves. In general, therefore, it seems that one should exercise caution before concluding that borrowing legal rules is a sufficient condition for legal pluralism within a legal system.

Accordingly, the conclusion drawn is that the substantive regulatory obligations introduced in the two countries are different from those in the source country. However, such a conclusion, on the face of it, seems to contradict the previous suggestion that, in theory, the regulatory duties concerning trading rules in secondary securities markets should have been transplanted into the national legal system without being changed.

Two possible explanations can be advanced for the existing differences. A possible explanation for this might be that, as a positive law enacted by the state, regulations are not intended to substitute for traditional law but to strengthen it and clarify its applicability and therefore need to be compatible with the institution of contract law of a country. The differences identified that exist, therefore, are a result of differences in traditional contract law.

Another possible explanation for this is the role of the authority in shaping the duty itself. The respective authorities have introduced both of the regulatory duties in both case studies, and hence it is the perception and the subjective judgement of the

⁸⁴⁹ Hamilton (n 600) and discussion in ch 3

regulator of what a regulatory duty entails that matters. This means that the entitlement and what the duty entails may not only depart from those of traditional law, but may also differ from time to time within one country. This suggests that, where it is possible for a regulatory duty to have several meanings, it is the view of the authority that counts.

The suggestion in the preceding paragraph leads to the conclusion that legal pluralism may occur not as a result of borrowing legal rules *per se*, but from the perception of the authority of what the legal rule is. This being the case, it follows that the effectiveness of a legal pluralism, once established, will depend strongly on the authority governing the markets itself. Such a conclusion may assist in enhancing our understanding of the role of the authority governing securities markets in the transplantation process in secondary securities markets.

It is also important to point out some preliminary remarks regarding the previous discussions. First, the two explanations are identified on the basis of our analysis as likely factors to influence the substantive obligations, but the analysis does not validate or negate either of them. It is possible for other, better, more accurate explanations, but they have not been identified in the analysis. Second, it should be emphasised that the conclusions are drawn from the analysis of the case studies included in the current thesis and, thus, it is important to be cautious since different criteria may result in different conclusions. For instance, the two duties examined are found to have existed before the intervention of the regulatory regime. It is not clear, however, if the suggestions would be valid in cases where introduced regulatory duty is novel, such as 'know your customers'.

Moreover, whereas an analysis of the regulatory rules themselves suggested a lower possibility of pluralism, a broader view of the regulatory regime may reveal

external factors from the rules themselves which could create legal pluralism. In the UK, for example, the requirement of the FOS to be fair, just and reasonable resulted in its ability to depart from traditional legal principles and norms, and, hence, the existence of legal pluralism for the application of both suitability and best execution as regulatory duties. Thus, it could be suggested that regulatory duties transplanted from a different legal system, while they are a necessary, are not a sufficient condition for legal pluralism.

The final sub-question presented in the introduction is whether or not those who draft legislation and hence shape securities markets law within a country should take into account the social and political context in addition to economic and administrative considerations.

So far, the discussion has emphasised two main specifications for effective securities markets: (a) the need for the predictability and certainty of law as a criterion to lower the level of legal risks, which is then able to facilitate economic growth; and (b) a need to ensure that investors have confidence in securities markets and engage fully with these markets. It is the role of policymakers and draftsmen to strike the appropriate balance between protecting investors and encouraging capital formation.

Unfortunately, the findings in this thesis suggest that there is no easy answer or common rational foundation to guide such choices in securities markets regulations in general, or private enforcement in particular. The two countries have adopted different approaches to the institutional structure of their regulatory frameworks for securities markets. For instance, the UK developed a unified regulator responsible for the conduct of the business of practitioners in all financial sectors, whereas Saudi Arabia chose a separate regulator for each financial sector and confined to the CMA responsibility for securities markets.

Such differences raise the question of whether or not the appropriate balance may differ from one country to another as far as suitability and best executions are concerned. It should be re-emphasised that the two regulatory duties of best execution and suitability were chosen in order to determine whether or not countries differ in their private enforcement of investor protection regulations in secondary securities markets. The thesis has shown that the two case study systems differ substantially and instrumentally. One of the more significant findings to emerge from the analysis of the private enforcement of regulatory duties is that regulatory doctrines are implemented differently through regulatory rules, even though participants put a high premium on achieving legal certainty and, accordingly, regulations are rationalized on the grounds, *inter alia*, that they reduce transaction costs by increasing certainty as well as maintaining investor confidence.

It was claimed in chapter two that, within the existing state of knowledge in the comparative literature on the private enforcement of securities market regulations, epistemological questions need to be addressed that are not answered by the currently promoted concepts of the optimal enforcement of securities market regulatory frameworks able to support economic growth. Nevertheless, in approaching the issue at hand, the thesis advanced three explanations for these differences.

Firstly, it could be hypothesised that differences exist between specific geopolitical entities in their regulatory regimes for secondary securities markets, including the private enforcement of regulations, because the economic policies that a society wishes to achieve differ. However, while this argument is powerful, it can be argued from a policy point of view that most countries state that their aim is to develop their securities markets in accordance with IOSCO's objective and principles, which is based on investor trust. Such a claim, notwithstanding the fact that IOSCO

does not provide a framework for private enforcement, is supported by one of this study's findings that suitability and best execution, as required by IOSCO principles, are found in both Saudi Arabia and the UK, but, nevertheless, they are implemented differently and different understandings exist of what they entail. Accordingly, it could be claimed that the impact of the policy on the structure of private enforcement of regulations is unclear, if not minimal.

Secondly, it may be hypothesised that differences arise because the policies pursued as well as the implementation process are affected by the costs of achieving different goals. To put this more clearly, some of these goals are explicit (regulatory objectives) and some are implicit (private interests). The implicit goals can be so strongly present and powerful as to affect the implementation process of policies and laws in such a way as to subvert the desired outcomes and stipulated methodologies developed to reflect accepted best practice as promoted by international organizations such as the IOSCO. Accordingly, the objective of investor protection, including private enforcement, is affected by national politics and differing cultures, particularly where there is a mismatch between what should have been done and what has been done. Subsequently, since it is common for private interest to prevail, differences between the political economies of countries result in different outcomes. This argument is supported in the analyses in chapter four which demonstrated that one problem identified in the UK regulatory regime was the restriction of private action for a breach of a regulatory rule, according to FS s.62A, to a 'private person'. Despite criticism at the time, this was carried forward into the current regulatory framework through s.150 of the FSMA.

However, while this hypothesis seems sound on the face of it, underlying such a claim is the assumption that there is an agreement between policymakers in the two

countries as to the policy, strategy, and means of implementation to reach certain outcomes. This study's analysis showed that there is no such detailed list of objective strategies and outcomes available to choose from and to be implemented, By way of illustration, the two countries differ as to the main objectives of the regulators as well as the instrument used to facilitate private enforcement of the regulatory framework. The two countries also differ in their regulatory regimes for private enforcement in implementation and indeed the relative importance of ensuring the perceived fairness of markets: the CML provides that the CMA should ensure that securities markets are fair, whereas the FSMA regime provides fairness as a standard to a class of investors eligible to bring a complaint before the FOS.

Finally, it can be hypothesised that, even when these policies are the same, they will be implemented differently and with different degrees of success because of the persistence of specific legal problems and contexts in which these legal rules are applied in secondary securities markets. The findings of this thesis support this premise. The legal differences are exemplified by the different legal instruments provided for private action: the FSMA through a tort for a breach of statutory duty, given the existence of such action in the previous regulatory regime; while the CML provides for a novel statutory anti-fraud cause of action given the uncertainty of the position of Shari'a law and Shari'a courts as well as the influence of foreign draftsmen. But so far, the analysis suggests that these legal problems do not impair an appropriate institutional design for the regulatory regime. The UK was able to introduce the financial ombudsmen scheme with binding awards upon service providers, subject to certain conditions. In contrast, the Saudi legal regime introduced the concept of regulatory private enforcement similar to that in the U.S. even though the country differs from the U.S both in substantial law and legal families.

In short, policymakers in both case studies were able, notwithstanding such legal problems, to overcome them and introduce what was deemed appropriate in achieving the broader social policy objectives. This suggests that, whereas following taking account of the legal context and considerations is important, it should not impair draftsmen from introducing a new instrument for the private enforcement of regulations within the legal context. The next section considers what an optimal framework for private enforcement should look like.

An Optimal Framework for Regulatory Private Enforcement

In order to clarify how an optimal framework for the private enforcement of regulations aiming to protect retail investors is able to increase the deterrence effect of the regulations, it is better to attempt to summarise the arguments of the previous chapters; taking the factors in the reverse order to that in which we have introduced them.

Saudi Arabia has introduced a system similar to that in the U.S. where private enforcement for breach of the statute is expressly provided; for instance, in cases of price manipulation. However, as far as suitability and best execution are concerned, whereas no direct right of enforcement is provided, it has been suggested that it is possible that a right for a private action would be recognised by reliance on the anti-fraud provision within CML. Another possible way to enforce the regulatory duties of suitability and best executions provided by the analysis in this thesis is through traditional tort actions. Thus, it is argued that it is more plausible that suitability and best execution would be more effectively enforced privately through traditional tort actions in order to avoid the higher burden of proof of fraud. But in both cases, however, a more central role for courts is relied on for effective enforcement, and that

is likely to re-introduce problems of the shortcomings of private enforcement identified within the U.S. legal context. Whereas absence of a class-action system may be likely to eliminate problems of over-enforcement, legal uncertainty as to the complexity of interaction between regulatory duties and traditional law persists. Such ambiguity is unlikely to support the development of law of securities markets in Saudi Arabia, given the lack of clarity and uncertainty about legal rules advanced by participants, academics and international organizations. Additionally, given that participants put a high premium on achieving legal certainty and, accordingly, regulations are rationalized on the ground, *inter alia*, that they reduce transaction costs by increasing certainty, the lack of a case reporting system in Saudi Arabia makes it impossible to conclude with certainty what the law is. The lack of clarity of the law has been pointed out in chapter two to be a substantial obstacle to enforcement, and given increased complexity and lack of clarity, it is reasonable to expect a low level of enforcement.

In contrast, the UK relies on a right of action based on tort for breach of statutory duties in terms of a breach of the rules imposed by the authority. This approach provides a clear recognition of the role of private enforcement while at the same time relies on the authority to decide its scope through identifying these rules which can be enforced privately and by which classes of investors. The institutional design of private enforcement has limited the power of the authority by providing such a right to a specific class of investors identified by the Treasury as ‘private investors’. Thus, as far as enforcement by retail investors is concerned, there are three terms which may possibly represent the concept of retail investors: ‘private investors’, ‘retail client’ and ‘eligible complainant’. As a result, few cases have been brought based on s.150, while express provisions are made by the FSMA to permit investors

to enforce a breach of a regulatory rule and seek damages. From the analysis of private enforcement in the UK, it is maintained that s.150 as it stands now might be unsuitable for the UK context; the fact that many complaints which are brought before the FOS and are rejected because of the cap limits, indicates that there is a potential for private enforcement alongside public enforcement at best, or to make up for the lack of public enforcement at worst.

But it was argued in chapter two that private enforcement should be able to increase the deterrence effects of regulations by providing additional sources for enforcement, compensate for lax enforcement and provide clarity of the law. An effective regulatory private enforcement designed to achieve this should deal effectively with three issues: (a) context-specific information about the regulatory problem; (b) the characteristics of the potential private plaintiffs; and (c) the effect of private enforcement on public enforcement efforts.

In terms of the institutional design of private enforcement, it is presumed that reliance on the judiciary for an implied right of action is likely to be inadequate, since it may result in over-enforcement and thus conflict with the deterrence objective of the regulations, as exemplified in the U.S., even before taking into account issues of the independence and resources of the judiciary as necessary conditions for the effective role of courts in securities markets.

Moreover, the effect of private enforcement on public enforcement efforts is maintained to depend on the overall public enforcement policy and strategy, which varies in practice and applications. But there is also the question of how regulations, such as those concerning suitability and best execution, that are intended to interfere with contractual relations can be adequately publicly enforced given that the analysis suggests that private agents are in a better position to identify violation. Public

enforcement is more effective in primary markets where regulations are able to standardise the terms of contracts and liabilities between issuers and subscribers. However, for secondary securities markets, enforcement agencies lack the ability to standardise the terms of contracts in similar vein to primary markets, and it is unclear how compliance with regulatory duties for these contracts can be supervised. Private agents, therefore, are more likely to be able to detect violations.

Having said that, the public agency responsible for regulating securities markets, as part of the executive branch, may be in a better position than the legislative or judiciary branches to make judgements as to when and how private enforcement is likely to increase the deterrence effect of regulations. In line with arguments advanced by supporters of public enforcement,⁸⁵¹ the regulatory agency has more knowledge, experience and resources to determine both the regulatory problems and what regulations aim for. Therefore, the regulatory agency has more experience and knowledge of the regulatory problems for which a specific regulatory duty is imposed. It follows that the agency is likely to be able to deal with the third issue concerning the effectiveness of private enforcement by measuring how and when best private enforcement complements public enforcement so as to support the agency's enforcement chosen policy and strategy. Therefore, the best policy solution is likely to be to delegate decisions regarding the extent and scope of private enforcement to the agency rather than leaving them to the courts.

Considering the significant role of the regulatory agency in current securities markets regulatory regimes, the two case studies also suggest that there is a significant role for this authority in the distribution of legal rights among

⁸⁵¹ See ch 2 Part II

participants.⁸⁵² In this thesis the subtle role of the authority has been emphasized in this process in determining who is eligible for substantive regulatory protection. The role of the FSA in determining the scope of private enforcement through the definition of ‘retail clients’ as a class of investors in need of additional regulatory protection, supports such a proposition. The position of the CMA in Saudi Arabia is similar, but with less clarity concerning outcomes due to the definition of a ‘customer’ for the purpose of the Implementing Regulations.

Given that current regulatory practices, as exemplified by the U.K. and Saudi Arabia, invest considerable authority and power in the regulatory agency in securities markets, it is a question of how to design a regulatory structure which can take advantages of such practices with the objective of enhancing the role of private enforcement.

It is argued that the institutional design for private enforcement should take into account the characteristics of retail investors when it comes to enforcement through litigation. It is pointed out that three variables are of importance: retail investors do not know they have a right to action; the substantive law is unclear, which increases the difficulties of litigation and uncertainty about its outcome; and there is a lack of incentives to pursue a cause of action. The characteristics of retail investors should be accorded higher significance, as the analysis in this thesis shows; whereas in Saudi Arabia it is argued that the difficulty is caused by the reliance on courts to imply such a right for action which increase uncertainty, the U.K.’s framework neglects the characteristics in retail investors for lacking the incentive to pursue a legal action.

⁸⁵² It should be noted that there is no issue with the distribution of legal rights through regulation since it is asserted that regulations are instruments used not only to prescribe the economic conduct of individuals in certain ways, but which can also be used to define spheres of influence, including the creation of rights. Hans Jarass, ‘Regulation as an Instrument of Economic Policy’ in Terence Daintith (ed), *Law as an Instrument of Economic Policy: Comparative and Critical Approaches* (Walter de Gruyter 1988) 79

It also suggested previously that it is the regulatory agency which is best suited to answer several questions as to the regulatory problems as well as the impact of private enforcement on the public enforcement. It is suggested, subsequently, an optimal framework for private enforcement should be relying on the regulatory agency to some extent.

Therefore, such an optimal framework for private enforcement should depend on a statutory cause of action with reliance on the regulatory agency, and also it could take into account the characteristics of retail investors and provide statutory remedies to enhance the role of private enforcement. There are many remedies available, some of which would aim to provide additional economic incentives, such as punitive damages or allowing for a class-action system, while others would involve the design of the right of action such as limitation periods, the burden of proof required and levels of compensation.

Accordingly, the optimal framework suggested by this thesis is one where the regulatory regime relies on the regulatory agency to determine what regulatory duties should be privately enforced by a right of action provided by the statute, taking into account the regulatory problems as well as the impact of private actions on public enforcement. The draftsmen of a statute should take into account certain shortcomings in the remedies in traditional private law identified within the national legal systems that might impair private action by retail investors, which could be corrected through the statute. It could be even possible, if there were adequate checks on the power of the regulatory agency, to allow the authority to preempt or bar specific remedies provided by the statute for specific breaches or particular regulatory duties.

A starting point for such a framework for private enforcement should be to look at s.150 in the U.K. rather than at s.10-(b) in the U.S. for the creation of the effective,

efficient private enforcement of regulations for securities markets. In fact, the framework introduced in the UK which relies on tort for a breach of statutory duty provides a blueprint that could be promoted internationally. First, it gives the regulatory authority the power to determine what regulatory duties could be privately enforced; secondly, it clearly institutes private enforcement within the institutional regulatory design; and thirdly, and most importantly, it takes into account the traditional law principles such as reliance and causation upon which the regulatory regime can rely. Finally, the U.K. approach permits flexibility for private enforcement to be restricted to specific classes of investors and not be available to all investors.

Two caveats need to be noted regarding the proposed framework. This is not the first study to argue for a framework which relies on the discretion of public agency in securities markets to control private enforcement.⁸⁵³ The previous researches have been based mainly on the analysis of and recommendations for the U.S. context. The proposal in this thesis has been built on the insights of prior work to make a more comprehensive and substantive argument for the broad delegation of power to regulatory agencies for securities markets concerning the existence and scope of private remedies. The thesis has surveyed existing practices in the two countries to identify the different frameworks available, and to subsequently propose a framework on the basis of the advantages and disadvantages identified in each case study. An important and practical finding is that, in building their regulatory regimes, other

⁸⁵³ Brianne Gorod, 'Case Comment, The Sorcerer's Apprentice: Sandoval, Chevron, and Agency Power to Define Private Rights of Action' (2004) 113 Yale L.J. 939, 944–46; Joseph Grundfest, 'Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority' (1994) 107 Harv. L. Rev. 961, 969–70; Richard Pierce, 'Agency Authority to Define the Scope of Private Rights of Action' (1996) 48 Admin. L. Rev. 1, 2; Stephenson (n 107)

countries should not look at the U.S. but rather at the U.K. for an effective regulatory private enforcement.

A second caveat in the analysis is the reliance in developed countries on alternative disputes resolutions or complaints systems as a means to solve complaints by retail investors in securities markets is evident. The cost and complexity of litigation as well as the interest of retail investors in concrete and immediate resolution means that ‘ombudsmen services, small claims tribunals, mediation services and other ADR techniques are central to the resolution of retail claims’.⁸⁵⁴ Within the EU, for example, the ADR rather than a right of action appears to be the best choice for a redress mechanism in the harmonised regulatory regime.⁸⁵⁵ Moloney correctly identified the suitability of ADR for the EU project rather than a right of action, since ‘it avoids some of the difficult questions concerning remedies and procedures which are engaged with civil redress through the courts.’⁸⁵⁶

Notwithstanding its benefits, such schemes rely more on the compensatory element rather than deterrence, which is not within the scope of this analysis. Furthermore, the reliance on the ADR process neglects an important element of the benefit of private enforcement, which is to spell out and provide certainty about the substantive law. In some cases, however, this may lead to confusion as to how to comply with securities markets regulations. For instance, in case of the FOS in the UK, the ability of ombudsmen to reach conclusions on the basis of what is ‘fair’, combined with their ability to depart from law, creates difficulties for financial firms in terms of how to comply with regulations.⁸⁵⁷ Particularly, the FSA imposes

⁸⁵⁴ Moloney (n 113) 451

⁸⁵⁵ MiFID Art. 53, which requires member states setting-up of ‘efficient and effective’ complaints and redress procedures for the out-of-court settlement of consumer disputes concerning investment services.

⁸⁵⁶ Moloney (n 113) 456

⁸⁵⁷ See ch 3 Part II

regulations and the FOS awards require them to comply with regulation in a fair and reasonable way. Through its principles the FSA requires firms to treat their customers fairly, but it is possible that a gap may exist between the FSA's perspective and the FOS. Such a gap is what critics of private enforcement warn about. That is not to say that the FOS is harmful, and indeed, the FOS is a good illustration from the perspective of distributive justice. However, from a deterrence perspective, the FOS in fact does not add to the deterrence benefits of the enforcement of regulations.

Overall, the design of an appropriate private enforcement framework for securities market regulations is a difficult but crucial task. While the foregoing discussion follows straightforwardly from analysis of the role of the enforcement of securities regulations, it also requires further reflection on administrative and constitutional law within a country. For instance, an optimal framework should take into account ensuring that the authority does not abuse its power and how and when to permit retail investors to sue the agency if it does not use its discretion or misuses it, or both. Such considerations should be answered within the specific constitutional, administrative and legal contexts, since what works for one country may not work for another. However, the paradigm for private enforcement proposed in this thesis should be able to take into account national differences more effectively and efficiently to achieve the broader social policy objectives underpinning securities markets regulations. The discussion in the next section therefore makes some recommendations for reform based on the proposed framework.

Recommendations for Reform

The UK

It was suggested in the conclusion of chapter three that there was room for some reform in order to enable the regulatory regime to serve the important underlying objective of enhancing the efficiency of the economy through increasing private enforcement through s.150. However, the UK government announced its intention to reform the law of financial markets during the writing of the present thesis.

The new institutional structure will give more consideration to regulations concerned with the conduct of business. The current government expresses the view that ‘the regulation of conduct in financial services has not always received the attention and focus that it requires within the integrated FSA’ even though the regulation of conduct ‘has a fundamental role to play in protecting and enhancing that confidence in the UK financial system’.⁸⁵⁸ In the opinion of the government, there should be ‘effective conduct regulation’ capable of ‘protecting and enhancing consumer confidence’ by, firstly, ‘setting out the standards to which firms are expected to adhere’; and, secondly, ‘monitoring and enforcing compliance by firms with these standards’.⁸⁵⁹ The rationale for such a perspective on the conduct of business regulations is the assumption that the willingness of investors to ‘enter into financial transactions will ultimately depend on the extent to which they have confidence that regulated firms will conduct themselves appropriately’.⁸⁶⁰ To achieve the desired end with regards to conduct regulation, a new institutional structure is needed to give this type of regulation ‘the required mandate and prominence’ by establishing ‘a separate and focused conduct regulator with tailored objectives,

⁸⁵⁸ HM Treasury, ‘A New Approach to Financial Regulation: Building a Stronger System’ (Treasury, February 2011) 59 <http://www.hm-treasury.gov.uk/consult_finreg_strong.htm> accessed 29 June 2011

⁸⁵⁹ Ibid

⁸⁶⁰ Ibid

functions and powers'.⁸⁶¹ The proposed new authority will be named the Financial Conduct Authority (FCA).

As far as retail investors are concerned, the FCA is expected to depart from the FSA's previous approach of 'scrutinising sales processes to make sure that customers were treated fairly and received appropriate and transparent information'. It will now intervene 'in the early stages of the product lifecycle where appropriate to deliver better outcomes for retail customers'.⁸⁶² Accordingly, the FCA will develop a 'proactive, interventionist approach' with 'a greater use of judgement, with the regulator using its expertise to judge where consumer detriment is most likely to occur, and intervene, on a forward-looking basis'.⁸⁶³

Interestingly, in line with the criticism offered in this study of the reliance on the disclosure approach to regulatory duties, the government admits that 'relying on the disclosure of information has not proven to be effective in preventing consumer detriment and protecting consumers'.⁸⁶⁴ Thus, the government is effectively relying on the judgement of the regulator to determine the appropriateness of financial products for retail investors, rather than the choices made by the retail investors themselves. To that end, the FCA is given a variety of powers to intervene, such as blocking a financial product before it reaches volume sales and declaring the unenforceability of contracts, without even the existence of 'widespread consumer detriment'.⁸⁶⁵

Thus, it is reasonable to expect that more consideration will be devoted to conduct regulation in the proposed regime, and it is likely that the FCA will be the

⁸⁶¹ Ibid

⁸⁶² Ibid, 60

⁸⁶³ Ibid, 69

⁸⁶⁴ Ibid

⁸⁶⁵ Ibid, 71

authority responsible for introducing and enforcing the duties of both suitability and best execution.

Regardless of any new institutional structure that will be in place, if the proposed regulatory regime will rely on an instrument similar to s.150 for private enforcement, then the argument made in this thesis concerning ineffectiveness of s.150 to facilitate private enforcement and deter malpractice remains valid. Moreover, the FCA should avoid some of the shortcomings identified in the COBS in respect of the classification of investors, the suitability of advice and best execution which have increased the ambiguity of the substantive law and are negatively affecting private enforcement.

Accordingly, and in answering the question as to the way forward and what courses of action could be suggested for improvement, the discussion in this research has highlighted many areas of concern.

Firstly, unless both the ambit and exact meanings of the requirement of suitability and what constitutes a personal recommendation are clearly defined, no improvement in private enforcement will be attained. Certainly, considerable improvement would have been achieved should the suitability duty imposed be seen as coterminous with a duty to achieve something (or a specified outcome) rather than to make reasonable efforts or take reasonable care. However, that would be difficult since it is unreasonable to hold a financial adviser to the outcome of products whose future performance is inherently uncertain, and it may reduce the engagement of service providers in advisory activities. One suggestion would be to detach the requirement of suitability from the requirement of advice and impose it on the selling process with the objective of ensuring that retail investors are not mis-sold unsuitable financial products. Another suggestion would be to provide more guidance as to when

financial advice should be considered a ‘personal recommendation’ under the proposed regulatory regime. One area of concerns is how suitability should be construed in relation to Internet activities; given that developments in technology and innovations in approaches to sales and distribution are still likely to create uncertainty.

Secondly, there is a need for legislative intervention to enhance the role of private enforcement. The present research suggests two areas that need attention: (1) a new punitive damages remedy for financial disputes should be introduced; and (2) a system similar to class-action in the US should be introduced at least within the financial services framework. The nature of certain regulatory rules, exemplified in this research by best execution, suggests that there is a need for these changes in order for these rules to be effective in private enforcement. The optimal situation would be to provide for punitive damages and a system similar to a class-action in the US, at least for financial services.

The idea of seeking damages for a group of investors is not unfamiliar within the FSMA regulatory regime or the English legal system in general. For example, Part XXV, s.382 of the FSMA gives the FSA the right to seek restitution through a court order from firms that have made profits or caused losses by acting in contravention of the regulatory requirements.⁸⁶⁶ Moreover, the English civil litigation system recognises multi-party procedures in the form of ‘group litigation’ and ‘representative proceedings’⁸⁶⁷ which, unlike the class-action system in the US,⁸⁶⁸ have had only a

⁸⁶⁶ The FSMA Part XXV s.384 delegates administrative powers to the FSA to order restitutions from authorised firms to the same effect.

⁸⁶⁷ Civil Procedure Rules 1998 (SI 1998/3132) r. 19.6 for ‘representative parties’ and r19.10 for ‘group litigation’.

⁸⁶⁸ Lord Woolf, *Access to Justice: Final Report* (Chancellor's Dept, 1996) ch17, para 16; Rachael Mulheron, *The Class Action in Common Law Legal Systems: A Comparative Perspective* (Hart 2004) ch 4

slight impact.⁸⁶⁹ Nevertheless, it is possible to extend these rights, with some amendment, by permitting investors to sue on behalf of each other. Further research might explore the applicability of such an idea to the English legal system.

Lastly, the approach to a diversity of classes of investors who enjoy different levels of substantive protection given by the regulations on different grounds needs to be amended. For the sake of certainty and clarity, a unified rationale for the protection of retail investors should be adopted, which would decrease the costs accruing to service providers. This could be achieved by restricting disputes which include the unified class of investors to the sole jurisdiction of the FOS. It would be possible for some to opt out of protection once they understood the consequences. In this case, financial firms would be able to assess the risk, including the legal risk of fairness, and including the applicability of the Principles to their business. Such an approach would not only furnish an element of fairness combined with the principles established in English law, but also provide certainty to legitimate legal expectations among both investors and service providers at the time of transacting.

Saudi Arabia

Given that Saudi policymakers introduced the CML, amongst other legislation, in response to the need for internal growth and job creation, it could be suggested that more substantive reform is needed in order for securities markets to achieve the wider social policy objectives. Developing securities markets is an ongoing process and policies aiming for such an objective 'should be persistent over a somewhat prolonged period of time'.⁸⁷⁰ There is no better time than now given the higher prices of oil; and empirical studies suggest that financial markets in oil-rich countries such

⁸⁶⁹ For critical analysis see Mulheron, *Ibid*, 68; Neil Andrews, *English Civil Procedure: Fundamentals of the New Civil Justice System* (OUP 2003) 972

⁸⁷⁰ Andrews, *ibid*

as Saudi Arabia tend to enhance economic growth gradually and in the long run following economic growth.⁸⁷¹ Thus, additional reforms taking into consideration the shortcomings of the current regulatory system are likely to support the economic growth expected later.

Indeed, in its assessment of Saudi financial markets, the IMF states that efforts made by the governments are praiseworthy, but insisted that ‘additional reforms could accelerate market deepening and the system’s capacity for risk diversification’.⁸⁷² Accordingly, it could be argued that further changes are needed to comply with international standards.

However, given the *ad hoc* approach of Saudi policymakers to legal issues, as identified in this research, it is not expected that any such reforms will be seriously considered unless and until a major crisis occurs. One benefit of these recommendations, nevertheless, is that they are available to policymakers once they do decide to conduct legal reform. The discussion in this thesis highlights many areas of concern.

Firstly, unless both suitability and personal recommendations are clearly defined, it would be difficult both for investors to enforce suitability and best execution and for service providers to determine whether or not a regulatory requirement has been fulfilled. This problem has been noted in the UK legal context where judicial judgements are published, and therefore it is reasonable to maintain that the problem is more acute in Saudi Arabia where there is no such publication.⁸⁷³

⁸⁷¹ Alif Darrat, ‘Are Financial Deepening and Economic Growth Causally Related? Another Look At the Evidence’ (1999) 13 International Economics Journal 19, 32; Thomas Lagoarde-Segot and Brian Lucey, ‘Efficiency in Emerging Markets: Evidence from the MENA Region’ (2008) 18 Journal of International Financial Markets, Institutions and Money 94

⁸⁷² Ibid

⁸⁷³ It should be noted that the Council of Ministers order no.162 1423 (2002) requested the Ministry of Justice to publish final judgements by Shari’a courts. The first collection of judgements was in 2008 and another two collections have been published by 2009. No further publications or explanations for the delay are available on the Ministry of Justice website. The collections and the procedure are

The regulator in Saudi Arabia would benefit from the recommendations advanced in the chapter three which examined the UK, but a step in the right direction would be to start by publishing decisions made by the CRSD and its appeals.

Secondly, there is a need for legislative intervention to increase the role of private enforcement in the CML regulatory regime in two areas. First, the Saudi context already suffers from high levels of uncertainty and, given the absence of general principles and the lack of published judgements, a reliance on traditional tort actions for the enforcement of regulatory duties as in the US increases uncertainty. A more appropriate approach that would suit the Saudi context is an instrument similar to s.150 provided by the FSMA in the UK, where a clear and direct right is provided in tort but it is left to the authority to decide the actionability of a given regulatory rule. This then avoids problems with the theoretical justifications of imposing suitability and best execution in normal tort actions. Second, given the importance of collective private enforcement as noted above in the UK and its absence in the Saudi legal system, it would be beneficial to provide the authority initially with the powers to enforce and seek damages on behalf of clients in a similar way to s.382 and 384 in the FSMA. A second step would be to provide a mechanism for collective enforcement, which has been critical not only for enforcement but also for the development of regulatory duties.

Thirdly, the definition of ‘investment advice’ subject to the jurisdiction of the CML regulatory regime should be amended. It is argued that the definition does not take into account the structure of financial markets in Saudi Arabia or the complexity inherent in structured financial products. However, caution must be exercised before suggesting either that all recommendations relating to securities be included within

accessible through the internet at <<http://www.moj.gov.sa/Arabic/JudicialBlog/Pages/versions.aspx>> accessed 29 June 2011

the jurisdiction of the CML, because this would include service providers from other sectors, or that all advice provided by authorised persons including recommendations as to non-securities should be under the CML, since this would be problematic given that there is no guidance or systematic approach to deal with overlapping jurisdictions among the regulators of different financial sectors. A better approach would be to subject all financial advice provided by authorised persons to the jurisdiction of the CML, and at the same time to provide fast and effective means to settle disputes relating to overlapping jurisdictions among regulators or tribunals. Such amendments are likely to facilitate private enforcement and compliance with the regulations.

Fourthly, the application of Shari'a principles should be developed to accommodate current circumstances so that its rulings can be codified without prejudice towards its established values. The provisions in the CML in relation to the amounts of damages and causation are good models that could be followed in such codification.

Fifthly, transparency and public access to law should be improved. Transparency is one of the most important elements of any successful legal system, but is largely lacking in Saudi Arabia. Details of the outcomes and reasoning in all cases should be published and the relevant provisions of the law of the judiciary with regard to the publication of court proceedings should be activated. This is necessary, as has been demonstrated in the present research, because with the CML as it stands now, a critical role is ascribed to the judiciary to clarify regulatory obligations and the scope of private enforcement. For example, it is unclear how suitability provisions in the Implementing Regulations will be construed in the light of the principles for business and statutory fiduciary duties. Furthermore, this would help in allowing the understanding of the position of Saudi law not only in relation to regulatory duties,

but also in constructing general principles of contracts, tort and obligations applicable to modern commercial and financial transactions.

Sixthly, the role of the formal stock-exchange (Tadawul) within the institutional arrangements should be reduced. The current arrangements do not take into account widely accepted international standards published by the World Bank, and neither will it be workable once the exchange becomes a listed company and faces competition.

Finally, the CML should clearly define certain important procedural issues, such as the limitation of the periods of disputes which arise within the CML framework. The present wording of the CML may suggest that the limitation period is restricted to the statutory cause of actions, and hence there is no time limitation on traditional tort.

Limitations of the Research

As with any other study concerning Saudi Arabia, the present author has struggled with many issues including the lack of publicly available information, details of court decisions and other official documents. Although tribunals are obliged to publish their decisions, the CRSD treats all of its decisions as secret. An attempt to gain access using personal connections to certain judicial decisions was of no avail on the grounds that the names of the parties to disputes should not be publicised. The Saudi system could never have been properly evaluated without the availability of the research paper by Beach or the single publication of the CSBD's general principles. These two publications were of great help in identifying policy considerations and the general principles of traditional tort law applicable to the resolution of financial disputes. Other problems, such as the paucity of literature on Saudi law in general and Saudi

financial law in particular, as well as on the impact of regulation on Shari'a principles as applied in Saudi Arabia, were obvious difficulties encountered on many occasions. The reader should also be reminded that, although some Arabic books in addition to some PhD theses have referred to these topics, they are usually somewhat descriptive, do not attempt to introduce any fundamental critical perspective on the Saudi legal system as a whole, and tend to be concerned mainly with the problem of the prohibition on interest in Islam and banking disputes.

Recommendations for Further Research

This thesis has identified many areas worthy of research in both countries. However, one of the main findings of this research is the observation in both countries of the importance of traditional tort law principles in the private enforcement of securities regulation. It is one thing to suggest that a pattern exists; it is quite another to do something useful with it. Thus, future comparative research may study whether or not divergence among countries with respect to the private enforcement of securities regulation may persist due to differences in traditional tort law. Of more practical importance for policymakers and draftsmen is how best to utilize traditional tort law in the private enforcement of securities regulation. The UK experience through an express action of tort for a breach of statutory duty is an example that could work as a model for such use, but caution should be exercised to avoid some of the issues identified in this thesis concerning its effectiveness as well as how a similar instrument would be effective in different legal systems such as those based on civil law or on a religious order such as Sharia law. While this thesis has proposed an optimal framework to accommodate such concerns, regulatory duties may still influence standards of care imposed by traditional law. Therefore, how securities

regulations eventually influence the substantive institution of private law, such as tort and contract, would be well worth examining.

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