

<New page>

<TITLE>**FINANCIAL REGULATORY GOVERNANCE IN SOUTH AFRICA: THE
MOVE TOWARDS TWIN PEAKS**

<AU>ANDREW SCHMULOW*

<A>**I. INTRODUCTION**

<T>The Twin Peaks model of financial system regulation calls for the establishment of two, independent, peak regulatory bodies, one charged with ensuring safety and soundness in the financial system, the other with preventing market misconduct and the abuse of consumers in the financial sector.

<NP>For reasons discussed elsewhere,¹ of the four models of financial system regulation,² Twin Peaks is regarded as best suited to this task.

<NP>The Twin Peaks model in general – and the Australian version of Twin Peaks in

* BA Honours LLB (Witwatersrand) PhD (Melbourne). Senior Lecturer in Law and Director designate, Business Law, School of Law, the University of Western Australia; Advocate of the High Court of South Africa; Principal, Clarity Prudential Regulatory Consulting, Pty Ltd; Visiting Researcher, Oliver Schreiner School of Law, University of the Witwatersrand, Johannesburg; Visiting Researcher, Centre for International Trade, Sungkyunkwan University, Seoul. The author may be contacted at: Andy.Schmulow@uwa.edu.au.

1 A. D. Schmulow, *Twin Peaks: A Theoretical Analysis*, Centre For International Finance and Regulation (CIFR) Research Working Paper Series, No. 064/2015/Project No. E018, Centre for International Finance and Regulation (CIFR) (1 July 2015).

2 See A. D. Schmulow, *Approaches to Financial System Regulation: An International Comparative Survey*, Centre For International Finance and Regulation (CIFR) Research Working Paper Series, No. 053/2015/Project No. E018, Centre for International Finance and Regulation (CIFR) (January 2015).

particular – is currently undergoing implementation in South Africa. This article explores issues related to that implementation from the perspective of governance as it is employed in Australia. The article commences with a discussion and an analysis of the historical development of Twin Peaks, followed by a discussion of governance. Next is an analysis of key differences between Twin Peaks in Australia and Twin Peaks as it is to be employed in South Africa. Finally there are concluding observations.

<NP>The article does not canvass the regulatory architecture of Twin Peaks as this has been done elsewhere,³ as have discussions on the need for and importance of inter-agency cooperation⁴ in Twin Peaks.

<A>II. HISTORICAL DEVELOPMENT

<T>The historical development of Twin Peaks provides an insight into its aims, which were principally a response to the phenomenon of the ‘blurring of the boundaries’ taking place between traditional financial firms in the United Kingdom. The model, which was first proposed by Michael Taylor in a pamphlet published by the Centre for the Study of Financial Innovation in 1994,⁵ was aimed, primarily, at the Bank of England. Australia was, however, the first country to adopt this model – a model which is now increasingly being emulated across the globe.

3 Schmulow, *supra*, note 2; A. D. Schmulow, ‘The Four Methods of Financial System Eglulation: An International Comparative Survey’, 26 (3) *Journal of Banking and Finance Law and Practice* (November 2015).

4 A. J. Godwin and A. D. Schmulow, ‘The Financial Sector Regulation Bill In South Africa: Lessons From Australia’, 132 (4) *South African Law Journal* (2015).

5 A. Hilton, *UK Financial Supervision: A Blueprint for Change*, Centre for the Study of Financial Innovation Working Paper, No. 6, Centre for the Study of Financial Innovation (May 1994).

A. The UK

<T>Prior to the advent of Twin Peaks, the UK's different overseers for conduct and systemic issues in the financial sector were so numerous that it was described as an 'alphabet soup'⁶ of regulators. Taylor argued at the time that those arrangements led to conflicts of interest, 'confusion and damage':⁷

<EXT>Britain's system for regulating financial services, as was once said of its Empire, has been acquired in a fit of absence of mind.⁸</EXT>

<T>The UK had a Byzantine system of disparate regulators, with each being assigned a jurisdiction defined by the type of entity being regulated. Contemporaneously, the financial system was increasingly experiencing a 'blurring of the boundaries' between different kinds of financial institutions. Banks were combining with insurers and investment banks with stockbroking firms. Added to this was the presence of large, systemically important building societies.⁹

<NP>The combination of these factors was identified as necessitating an overarching financial services regulator, the purpose of which would be to ensure the stability of the financial system.¹⁰

<NP>This idea – one combined financial services regulator – became the first half of

6 M. W. Taylor, 'Twin Peaks': *A Regulatory Structure for the New Century*, no. 20, Centre for the Study of Financial Innovation, No. 20 (December 1995), at p. 77.

7 *Ibid.*, at pp. 1–3.

8 *Ibid.*, at p. 2.

9 *Ibid.*, at p. 4.

10 *Ibid.*, at p. 1.

a more substantial proposal – ‘Twin Peaks’. Taylor¹¹ argued for a fusion of the multiple regulators then in existence – regulators charged with banking, securities, insurance and investment management. These regulators included the Bank of England, the Building Societies Commission¹² and the Securities and Investments Board (SIB).¹³

<NP>Under Taylor’s plan, a new financial services regulator would henceforth assume authority for all deposit-taking institutions¹⁴ and, crucially, would no longer simply enforce bank regulations against individual transactions. It would be charged with ensuring the overall stability of the financial system by regulating bank capital and the control of risk.¹⁵

<NP>Specifically, Taylor envisaged that the bank regulator would address the ‘financial soundness of institutions – including capital adequacy and large exposure requirements, measures relating to systems, controls and provisioning policies, and the vetting of senior managers to ensure that they possessed an appropriate level of experience and skill.’¹⁶ The collapse of Barings Bank¹⁷ in 1995 provided further impetus¹⁸ for the adoption of a single bank regulator.

<NP>Under Taylor’s proposal a second regulator would then be created, charged with

11 Hilton, *supra*, note 5.

12 Taylor, *supra*, note 6, at p. 3.

13 Hilton, *supra*, note 5, at p. 2.

14 Taylor, *supra*, note 6, at p. 4.

15 *Ibid.*, at p. 1.

16 *Ibid.*, at p. 3.

17 For more on this see S. Fay, *The Collapse of Barings*, W. W. Norton (1997); A. Tickell, ‘Making a Melodrama Out of a Crisis: Reinterpreting the Collapse of Barings Bank’, 14 (1) *Environment and Planning D: Society and Space* (1996); for a critical theory analysis see A. D. Brown, ‘Making Sense of the Collapse of Barings Bank’, 58 (12) *Human Relations* (2005).

18 Taylor, *supra*, note 6, at p. 2.

protecting consumers from unscrupulous operators: a market conduct and consumer protection regulator,¹⁹ the remit of which would be to ensure that consumers were treated fairly and honestly²⁰ by protecting them against ‘fraud, incompetence, or the abuse of market power’,²¹ Measures would include restrictions on the advertising, marketing and sale of financial products, as well as minimum fit and proper standards for salespeople.²² In the event of conflict between the two regulators, the Chancellor of the Exchequer would provide a resolution.

<NP>According to Taylor,²³ this would address four issues simultaneously:

<NL>

1. that henceforth a wide range of financial firms would have to be regarded as systemically important;
2. that sprawling and disparate regulatory agencies be regarded as presenting opportunities for regulatory arbitrage²⁴ and turf battles over jurisdiction;²⁵
3. that in the ever increasing cases of financial conglomerates, a group-wide perspective

19 *Ibid.*, at p. 1.

20 *Ibid.*, at p. 1.

21 *Ibid.*, at p. 3.

22 *Ibid.*, at p. 3.

23 *Ibid.*, at p. 4.

24 And *ibid.*, at p. 7: ‘[the same phenomenon that creates the potential for regulatory arbitrage also creates the possibility for] important issues to “disappear down the gaps”, and . . . among consumers [confusion is created] by an “alphabet soup” of regulatory bodies’. See also D. T. Llewellyn, *Institutional Structure of Financial Regulation and Supervision: The Basic Issues*, paper presented at the World Bank seminar *Aligning Supervisory Structures with Country Needs*, Washington, DC (6 and 7 June 2006), at p. 10 (§ 1).

25 Taylor, *supra*, note 6, at p. 11.

on financial soundness would be addressed;²⁶ and

4. that rare and specialist expertise and limited supervisory resources would be pooled, instead of duplicated by overlapping.

<EXT>The benefits of Twin Peaks are clear. The proposed structure would eliminate regulatory duplication and overlap; it would create regulatory bodies with a clear and precise remit; it would establish mechanisms for resolving conflicts between the objectives of financial services regulation; and it would encourage a regulatory process which is open, transparent and publicly accountable.²⁷</EXT>

<EXT>These examples show why structure does, and should matter, if we wish to create an efficient, effective system of financial services regulation.²⁸</EXT>

<T>While Llewellyn²⁹ takes a contrary view, arguing that specialist agencies are easier to hold to their objectives, in Australia the failures that have occurred under each of the two, integrated regulators, have not been due to confusion over objectives.³⁰ Rather, they have

26 *Ibid.*, at p. 5, Taylor discusses the issue of psychological contagion, that is to say a collapse in depositor confidence, not because an entity is directly involved in a loss, but because another entity – a subsidiary – another part of the same conglomerate, is involved in a loss. This possibility – that retail depositor panic can set off a bank run across all associated entities – underscores the importance of a whole-of-entity approach to regulation. See also Llewellyn, *supra*, note 24, at p. 9.

27 Taylor, *supra*, note 6, at p. 1. See also Llewellyn, *supra*, note 24, at p. 28.

28 M. W. Taylor, *Peak Practice: How to Reform the UK's Regulatory System*, Centre for the Study of Financial Innovation, No. 23 (October 1996), at p. 17.

29 Llewellyn, *supra*, note 24, at p. 26.

30 See further P. McConnell, 'War on Banking's Rotten Culture Must Include

been due to a weak enforcement culture which has bedevilled especially the market conduct and consumer protection peak and to which this article will return.

<NP> Similarly, Llewellyn argues that integrated agencies are more likely to suffer reputational harm, due to the failures of one particular division within the agency and, as a result, consumer confidence in the regulator may be weakened.³¹ This argument does comport with the Australian experience, in relation to the manner in which the market conduct and consumer protection agency has handled an ongoing series of financial advice scandals.³²

Regulators’, *The Conversation*, 4 June 2015, 2.14 p.m. AEST, available at <http://theconversation.com/war-on-bankings-rotten-culture-must-include-regulators-42767>; M. Williams, ‘APRA and ASIC Need Cultural Shift’, *Asia-Pacific Banking and Finance*, 9 March 2015, available at <https://www.australianbankingfinance.com/banking/apra-and-asic-need-cultural-shift/>; A. Schmulow, ‘To Clean Up the Financial System We Need to Watch the Watchers’, *The Conversation*, 4 March 2015, 2.11 p.m. AEDT, available at <http://theconversation.com/to-clean-up-the-financial-system-we-need-to-watch-the-watchers-38359>; A. Ferguson, ‘Hearing into ASIC’s Failure to Investigate CBA’s Financial Wisdom’, *Sydney Morning Herald*, 3 June 2014, available at <http://www.smh.com.au/business/hearing-into-asics-failure-to-investigate-cbas-financial-wisdom-20140602-39ept.html>; P. McConnell, ‘ASIC’s Fashion Faux-Pas’, *The Conversation*, 13 July 2015, 4.25 p.m. AEST, available at <https://theconversation.com/asics-fashion-faux-pas-44590>.

31 See, for example, his remarks in Llewellyn, *supra*, note 24, at p. 28.

32 For more on this see Schmulow, *supra*, note 1, at pp. 43ff.

B. Australia³³

<T>The ‘Twin Peaks’ model was proposed by, and implemented on, the conclusion of the Wallis Commission of Inquiry in 1997.³⁴ In the case of the prudential regulator (PA), this replaced 11 separate regulators.³⁵ To wit, Australia separated the market conduct and consumer protection authority – the Australian Securities and Investment Commission (ASIC) – from the bank regulator – the Australian Prudential Regulation Authority (APRA) – and the National Central Bank (NCB) – the Reserve Bank of Australia (RBA).³⁶ Crucially, APRA is not a division of the RBA, whereas in other jurisdictions that have adopted Twin Peaks, the PA has been incorporated as a division of the NCB, and this is the arrangement envisaged for South Africa.³⁷

<NP>Under Twin Peaks, the RBA is tasked with, *inter alia*, overall responsibility for the financial system and as lender of last resort (LLR).³⁸ The Australian model could, therefore, reasonably have been described as a three-peak model, with each peak created as

33 Elements of this section appeared in substantial part in a previous article, published as a working paper by the Centre for International Finance and Regulation: Schmulow, *supra*, note 2, at pp. 40ff.

34 S. Wallis, B. Beerworth, J. Carmichael, I. Harper and L. Nicholls, *Financial System Inquiry*, The Treasury, 31 March 1997. See also J. Black, ‘Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulation Authority’, 28 (1) *Law and Policy* (January, 2006), 4–5.

35 Black, *supra*, note 34, at p. 5.

36 Also created was the Australian Competition and Consumer Commission (ACCC). If the ACCC is to be included, then the Australian model is in fact a ‘quad peak’ model. Llewellyn, *supra*, note 24, at p. 17.

37 Godwin and Schmulow, *supra*, note 4, at p. 758.

38 John Trowbridge, *The Regulatory Environment – A Brief Tour*, paper presented at the National Insurance Brokers Association (NIBA) Conference, Sydney, NSW (22 September 2009), Table, p. 2.

an independent, statutory body.³⁹

<NP>In respect of governance, in 1999 APRA moved to a risk-based approach to supervision.⁴⁰ In 2002⁴¹ APRA codified its risk-based approach to financial regulation with the introduction of the ‘probability and impact rating system’ (PAIRS)⁴² and the ‘supervisory oversight and response system’ (SOARS).⁴³

<NP>PAIRS is a framework for assessing how ‘risky’ an institution is vis-à-vis APRA’s objectives; SOARS determines how officials respond to that risk.⁴⁴ While PAIRS examines a number of internal risk indices,⁴⁵ a glaring omission is its failure to provide a formal assessment of industry-wide risks,⁴⁶ which are particularly germane in an industry

39 *Australian Securities and Investments Commission Act (Cth)*, No. 51 of 2001, (Australia); *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998, (Australia); *Reserve Bank Act (Cth)*, No. 4 of 1959 (Australia). Independence in this context is a term of art describing the relationship between the two peaks. It is not meant to describe the relationship between the peaks and government; in that respect their independence is heavily limited. APRA, for example, is subject to limited direction from the Minister: section 12, *Australian Prudential Regulation Authority Act (Cth)*, No. 50 of 1998.

40 Black, *supra*, note 34, at pp. 5–6.

41 Australian Prudential Regulation Authority, *Probability and Impact Rating System*, Australian Prudential Regulation Authority (June 2012), available at <http://www.apra.gov.au/CrossIndustry/Documents/PAIRS-062012-External-version.pdf>, p. 5.

42 For more, see Australian Prudential Regulation Authority, ‘Supervision’, in *About APRA*, Australian Prudential Regulation Authority (undated) (accessed 31 July 2015), available at <http://www.apra.gov.au/AboutApra/Pages/Supervision.aspx>; Black, *supra*, note 34, at pp. 10ff.

43 Black, *supra* note 34, at pp. 8ff.

44 *Ibid.*, p. 8.

45 See *ibid.*, p. 11.

46 *Ibid.*

susceptible to contagion.

<NP>PAIRS differentiates the risk profile of regulated institutions into five categories: low, lower medium, upper medium, high and extreme.⁴⁷ A similar system was used in the UK prior to the global financial crisis (GFC) and the ensuing collapse of the Royal Bank of Scotland. As a result the efficacy of this ratings matrix is questionable. In evaluating the ratings system used to assess the riskiness of the Royal Bank of Scotland, Hosking states:

<EXT>The report is a blizzard of acronyms and bogus science: RBS was scored as a ‘medium high minus’^[48] risk, whatever that is . . .⁴⁹ </EXT>

<T>A key aspect of PAIRS is that it works on a multiplier not a linear scale.⁵⁰ This results in a higher SOARS scale, which in turn, it is argued, compels a more aggressive supervisory response.⁵¹

<NP>In terms of the potential impact that a regulated entity might have on the

47 Australian Prudential Regulation Authority, ‘Probability and Impact Rating System, Chapter 8 – Probability of failure’, in *About APRA: Probability and Impact Rating System*, Australian Prudential Regulation Authority (June 2012) (accessed 5 August 2015), available at <http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx>.

48 For details on this rating, see Financial Services Authority, ‘The Failure of the Royal Bank of Scotland’, in *Financial Services Authority Board Report*, Part 2, Chapter 3, Financial Services Authority (December 2011), p. 260 (§ 683).

49 P. Hosking, ‘More Lever-Arch Files Wouldn’t Have Saved RBS’, *The Times* (morning edn), Tuesday, 13 December 2013.

50 Black, *supra*, note 34, at p. 12.

51 *Ibid.*

financial system, this is divided into four categories: low, medium, high and extreme.⁵² This rating is determined relative to the regulated entity's total Australian resident assets, 'subject to a management override that can raise or lower the impact depending on senior management's assessment'.⁵³ In this regard Black asserts that:

<EXT>There was little science involved in determining the dividing lines between the ratings, it was more a question of whether the overall result seemed to make sense ...⁵⁴ </EXT>

<T>What this flexibility belies, however, is a lack of coherent methodology. Rather, reliance is made on intuition and supposition. There is, however, a wealth of evidence from psychology that 'gut instincts' are frequently unreliable.⁵⁵ Evidence of the failure of this approach is to be found in the rogue trading scandal at National Australia Bank, which resulted in losses of \$360 million to the bank, and which APRA ascribed to 'cultural issues'.⁵⁶

52 Australian Prudential Regulation Authority, 'Probability and Impact Rating System, Chapter 9 – Impact of Failure', in *About APRA: Probability and Impact Rating System*, Australian Prudential Regulation Authority (June 2012) (accessed 5 August 2015), available at <http://www.apra.gov.au/AboutAPRA/Pages/PAIRS-1206-HTML.aspx>.

53 Black, *supra*, note 34, at p.13.

54 *Ibid.*

55 See, for example, the work of Kahneman, 2002 Nobel Laureate in Economic Sciences, in D. Kahneman, *Thinking, Fast and Slow*, 1st edn, Farrar, Straus & Giroux (2011).

56 Australian Prudential Regulation Authority, *Report into Irregular Currency Options Trading at the National Australia Bank*, Australian Prudential Regulation Authority (23 March 2004), p. 6.

C. The Netherlands⁵⁷

<T>The Kingdom of the Netherlands was second to adopt a Twin Peaks approach in 2002,⁵⁸ retaining prudential supervision within De Nederlandsche Bank NV⁵⁹ ('The Dutch Bank' (DNB)). This is similar to the arrangement in the UK, but distinct from Australia, where, as mentioned previously, the prudential regulator (APRA) is separate from the NCB.

<NP>The Dutch copied the Australian approach, particularly as it applied to supervisory strategy – PAIRS and SOARS – both of which the Dutch regulator, the DNB, adopted.⁶⁰

<NP>While the Netherlands, under a Twin Peaks regime, managed to stave off the worst of the GFC, success for the Dutch authorities in an economy with such an important

57 Elements of this section appeared in a previous article, published as a working paper by the Centre for International Finance and Regulation: Schmulow, *supra*, note 2, at pp. 33ff.

58 International Monetary Fund, 'Kingdom of the Netherlands – Netherlands: Publication of Financial Sector Assessment Program Documentation – Technical Note on Financial Sector Supervision: The Twin Peaks Model', in *Financial Sector Assessment Program Update*, IMF Country Report No. 11/208, International Monetary Fund (July 2011), Table 1, p. 6. See also H. Prast and I. van Lelyveld, *New Architectures in the Regulation and Supervision of Financial Markets and Institutions: The Netherlands*, DNB Working Paper No. 021/2004, De Nederlandsche Bank (21 December 2004).

59 De Nederlandsche Bank, 'DNB Supervisory Strategy 2010–2014', in *Supra-Institutional Perspective, Strategy and Culture*, De Nederlandsche Bank (April 2010), p. 21; E. Wymeersch, 'The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors', 8 (2) *European Business Organization Law Review (EBOR)* (June 2007), 16.

60 J. Black, 'Regulatory Styles and Supervisory Strategies', Chapter 8, in *The Oxford Handbook of Financial Regulation*, eds N. Moloney, E. Ferran and J. Payne, Oxford University Press (August 2015), 262.

financial sector was not achieved without ‘drastic’⁶¹ government intervention:⁶²

<EXT> Total foreign claims of Dutch banks amounted to over 300% of GDP. The Dutch financial system therefore depended heavily on external developments. Only the Belgian and Irish banking sectors were in a similar position. The European average was less than half the Dutch figure at 135% of GDP . . . exposure of Dutch banks to the United States also was the highest in Europe, at 66% of GDP . . . whereas the average of European banks had kept limited exposure of less than 30% of GDP. By contrast, the exposure of Dutch banks to hard-hit Eastern European countries was at 11% of GDP just above the European average of 8% of GDP.⁶³ </EXT>

<T> Intervention during the crisis took the form of measures to stimulate employment through: construction and housing (€6 billion); capital injections for banks and insurers (€20 billion); state guarantees for banks (€200 billion); a guarantee on all deposits up to €100,000;⁶⁴ the nationalisation of Fortis/ABN AMRO (€16.8 billion), the ING banking group (€10 billion) (comprising 85 per cent of the Dutch banking sector⁶⁵) and the SNS REAAL

61 De Nederlandsche Bank, ‘Annual Report 2009’, *De Nederlandsche Bank NV* (24 March 2010), p. 37 and Chart, p. 45.

62 See further Black, *supra*, note 60, at p. 47 (fn 128).

63 M. Masselink and P. van den Noord, ‘The Global Financial Crisis and Its Effects on the Netherlands’, 6 (10) *ECFIN (Economic Analysis from the European Commission’s Directorate-General for Economic and Financial Affairs) Country Focus* (4 December 2009), 3.

64 Ministry of Finance, Government of the Netherlands, ‘The Netherlands and the Credit Crisis’, in *Financial Policy*, Ministry of General Affairs (undated) (accessed 11 January 2015).

65 M. Van Oyen, ‘Ringfencing or Splitting Banks: A Case Study on The Netherlands’, 19

insurance and banking group (€3.7 billion);⁶⁶ and a reform of the financial system and the capital levels that had been enforced to date. Thereafter the Dutch government was compelled to drastically reduce spending in order to reduce its deficit.⁶⁷

<NP>In the aftermath of the crisis, the conclusions reached about the performance of the Dutch regulators were less than positive:

<EXT>Both in the run-up to and during the credit crisis, supervisory instruments fell short in several areas. These deficiencies emerged in both the scope and the substance of supervision. The trend towards lighter supervision, reflecting developments within the financial sector as well as changed social attitudes, [had] gone too far.⁶⁸ </EXT>

<T>This finding supports the conclusions reached in the analysis of the performance of the UK regulatory authorities during the GFC, namely that regulatory architecture alone is not a panacea against financial crises. Doubtless regulatory architecture is part of the solution, but no more so than the capacity of the regulators to foresee, at times, the unforeseeable⁶⁹ and regulate accordingly, and the willingness of the regulators to enforce their regulations.

(1) *Columbia Journal of European Law Online* (Summer 2012), 6.

66 T. Escritt and A. Deutsch, 'Netherlands Nationalizes SNS Reaal at cost of \$5 billion', *Reuters*, United States edn (Friday, 1 February 2013, 6:30 a.m.).

67 Ministry of Finance, Government of the Netherlands, *supra*, note 64.

68 De Nederlandsche Bank, *DNB Supervisory Strategy 2010–2014 and Themes 2010*, De Nederlandsche Bank (April 2010), 5.

69 See, for example, M. Douglas and A. Wildavsky, *Risk and Culture: An Essay on the Selection of Technological and Environmental Dangers*, revised edn, University of California Press (1983), 1, where the authors state: 'Can we know the risks we face, now or in the future? No, we cannot; but yes, we must act as if we do.'

D. South Africa

<T>For South Africa the problem of the current regulatory structure was highlighted, with a degree of disapproval, by the Financial Sector Assessment Program (FSAP) Report, conducted by the International Monetary Fund (IMF) and the World Bank (WB) in 2008.⁷⁰ As a result, the National Treasury of the Republic of South Africa, in its 2011 Report,⁷¹ identified financial regulatory reform as a necessity, and committed the Republic to adopting a Twin Peaks model of financial regulation,⁷² modelled broadly on that currently in use in Australia.

<NP>Historically South Africa had adopted an institutional approach in which banks, insurers and capital markets were regarded as separate species.⁷³ Regulation was typified by a lack of coordination.⁷⁴

<NP>The 1987 de Kock Commission Report, chaired by Dr Gerhardus de Kock, later Governor of the South African Reserve Bank, reformed the regulatory system in South Africa, and implemented a functional financial regulatory approach.⁷⁵

<NP>While the 1993 Melamet Commission, chaired by Judge David Melamet, recommended a single regulator, the regulatory system has remained functional and partially

70 S. Kal Wajid, 'South Africa: Financial System Stability Assessment, Including Report on the Observance of Standards and Codes on the Following Topic: Securities Regulation', in *Financial System Stability Assessment*, no. 08/349, International Monetary Fund (October 2008).

71 Republic of South Africa National Treasury, 'A Safer Financial Sector to Serve South Africa Better', in *National Treasury Policy Document*, National Treasury, Republic of South Africa (23 February 2011).

72 *Ibid.*, p. 5.

73 D. Rajendaran, 'Approaches to Financial Regulation and the Case of South Africa', *IFMR Finance Foundation* (6 March 2012).

74 *Ibid.*

75 *Ibid.*

integrated.⁷⁶ Currently the financial system is regulated by the South African Reserve Bank (SARB)⁷⁷ and the Financial Services Board (FSB).⁷⁸ The FSB is a statutory body charged with the task of overseeing the non-bank financial industry (NBFI),⁷⁹ which in turn is currently covered by 12 separate pieces of legislation plus its own enabling Act.⁸⁰ In respect of NBFIs, the FSB has a market abuse remit, carried out by the Directorate of Market Abuse (DMA).⁸¹ Market abuse in terms of the Financial Markets Act consists of insider trading,⁸²

76 *Ibid.*

77 South African Reserve Bank Act, No. 90 of 1989 (Republic of South Africa).

78 Financial Services Board Act, No. 97 of 1990 (Republic of South Africa).

79 Financial Services Board, 'Welcome to the FSB', in *About Us*, Financial Services Board (1996–2013) (accessed 17 August 2014), available at <https://www.fsb.co.za/aboutUs/Pages/default.aspx>.

80 Collective Investment Schemes Control Act, No. 45 of 2002 (Republic of South Africa); Credit Rating Services Act, No. 24 of 2002 (Republic of South Africa); Financial Advisory and Intermediaries Services Act (FAIS Act), No. 37 of 2002 (Republic of South Africa); Financial Institutions (Protection of Funds) Act, No. 28 of 2001 (Republic of South Africa); Financial Markets Act, No. 19 of 2012 (enacted 1 February 2013) (Republic of South Africa); Financial Services Board Act, No. 97 of 1990; Financial Services Ombud Schemes Act, No. 37 of 2004 (enacted 9 February 2005) (Republic of South Africa); Financial Supervision of the Road Accident Fund Act, No. 8 of 1993 (Republic of South Africa); Friendly Societies Act, No. 25 of 1956 (Republic of South Africa); Inspection of Financial Institutions Act, No. 80 of 1988 (Republic of South Africa); Long-term Insurance Act, No. 52 of 1998 (Republic of South Africa); Pension Funds Act, No. 24 of 1956 (Republic of South Africa); Short-term Insurance Act, No. 53 of 1998 (Republic of South Africa).

81 Financial Services Board, 'Market Abuse', in *About Us*, Financial Services Board (1996–2013) (accessed 17 August 2014), available at <https://www.fsb.co.za/departments/marketAbuse/Pages/Home.aspx>, and created pursuant to section 85 of the Financial Markets Act, No. 19 of 2012.

82 Prohibited by section 78, Financial Markets Act, No. 19 of 2012.

market manipulation⁸³ and false reporting.⁸⁴

<NP>The prohibitions against market abuse, the Directorate's powers to investigate and the administrative sanctions and penalties which the Directorate may bring to bear are set out in Chapter X⁸⁵ of the Financial Markets Act⁸⁶ for offences committed after 3 June 2013. For offences alleged to have taken place prior to 3 June 2013, the provisions of Chapter VIII⁸⁷ of the Securities Services Act⁸⁸ will apply.

<NP>Currently, the Financial Advisory and Intermediary Services Act⁸⁹ is in force and has as one of its principal aims the protection of consumers.⁹⁰

83 Prohibited by section 80, *ibid.*

84 Prohibited by section 81, *ibid.*

85 Sections 77 to 89, *ibid.*

86 *Ibid.*

87 Sections 72 to 87, Securities Services Act, No. 36 of 2004 (Republic of South Africa).

88 *Ibid.*

89 Financial Advisory and Intermediary Services Act, No. 37 of 2002 (Republic of South Africa).

90 Financial Services Board, 'Financial Advisory and Intermediary Services', in *Regulatory Examinations*, Financial Services Board (1996–2013) (accessed 17 August 2014), available at <https://www.fsb.co.za/Departments/fais/Pages/Regulatory-Examinations.aspx>. 'Undesirable Practices', section 34(1), Financial Advisory and Intermediary Services Act, No. 37 of 2002, which states: 'Subject to subsections (2) and (3), the registrar may by notice in the Gazette declare a particular business practice to be undesirable for all or a category of authorised services providers, or any such provider' (subsequently replaced by section 196(a), Financial Services Laws General Amendment Act, No. 45 of 2013 (Republic of South Africa), which states: '(1) Subject to subsections (2) and (3), the registrar may by notice in the Gazette declare a particular business practice to be undesirable for all or a category of authorised services providers, or any such provider'). Section 34(2), Financial Advisory and Intermediary Services Act, No. 37 of 2002, which states:

<EXT>(2) The following principles must guide the registrar in considering whether or not a declaration contemplated in subsection (1) should be made: (a) That the practice concerned, directly or indirectly, has or is likely to have the effect of – (i) harming the relations between authorised financial services providers or any category of such providers, or any such provider, and clients or the general public; (ii) unreasonably prejudicing any client; (iii) deceiving any client; or (iv) unfairly affecting any client; and (b) that if the practice is allowed to continue, one or more objects of this Act will or is likely to, be defeated. (3) The registrar may not make such a declaration unless the registrar has by notice in the Gazette published an intention to make the declaration, giving reasons therefor [*sic*], and invited interested persons to make written representations thereon so as to reach the registrar within 21 days after the date of publication of that notice. (4) An authorised financial services provider or representative may not, on or after the date of the publication of a notice referred to in subsection (1), carry on the business practice concerned.</EXT>

Subsequently replaced by section 196(b), Financial Services Laws General Amendment Act, No. 45 of 2013, which states: ‘(4) An authorised financial services provider or representative may not, on or after the date of the publication of a notice referred to in subsection (1), carry on the business practice concerned’. Section 34(5), Financial Advisory and Intermediary Services Act, No. 37 of 2002, states:

<EXT>The registrar may direct an authorised financial services provider who, on or after the date of the publication of a notice referred to in subsection (1), carries on the business practice concerned in contravention of that notice, to rectify to the satisfaction of the registrar anything which was caused by or arose out of the carrying on of the business practice concerned: provided that the registrar may not make an order contemplated in section 6D(2)(b) of the Financial Institutions (Protection of Funds) Act [*sic*] 2001 (Act No. 28 of 2001).</EXT>

Subsequently replaced by section 60(a), Financial Services Laws General Amendment Act, No. 22 of 2008 (Republic of South Africa), which states:

<EXT>by the substitution for subsection (5) of the following subsection: ‘(5) The

<NP>In addition, there are consumer protection provisions which are enforced by the Office of the Ombud for Financial Services Providers (FAIS Ombud).⁹¹ The Ombud is a statutory body⁹² empowered to deal with complaints against financial institutions which do not fall within the jurisdiction of any other ombud scheme or where there is uncertainty over jurisdiction.

<NP>Currently, deposit-taking banks are regulated by the Banking Supervision

registrar may direct an authorised financial services provider who, on or after the date of the publication of a notice referred to in subsection (1), carries on the business practice concerned in contravention of that notice, to rectify [or reinstate] to the satisfaction of the registrar [any loss or damage] anything which was caused by or arose out of the carrying on of the business practice concerned: provided that the registrar may not make an order contemplated in section 6D(2)(b) of the Financial Institutions (Protection of Funds) Act, 2001 (Act No. 28 of 2001)’. </EXT>

Section 34(6), Financial Advisory and Intermediary Services Act, No. 37 of 2002, which states: ‘An authorised financial services provider concerned who is under subsection (5) directed to rectify anything, must do so within 60 days after such direction is issued.’ (Subsequently replaced by section 60(b), Financial Services Laws General Amendment Act, No. 22 of 2008, which states: ‘by the substitution for subsection (6) of the following subsection: “(6) An authorised financial services provider concerned who is under subsection (5) directed to rectify [or reinstate] anything, must do so within 60 days after such direction is issued”’.)

91 The Office of the Ombud for Financial Services Providers, ‘Welcome to FAIS Ombud’, Office of the Ombud for Financial Services Providers (2012–14) (accessed 17 August 2014), available at <http://www.faisombud.co.za>.

92 Established by the Financial Advisory and Intermediary Services Act, No. 37 of 2002. From 1 April 2005, the FAIS Ombud was created as a Statutory Ombud under the Financial Services Ombud Schemes Act, No. 37 of 2004, giving the entity original jurisdiction.

Department (BSD) of the SARB.⁹³ In addition, the National Credit Regulator⁹⁴ has as its objective to promote fairness in accessing consumer credit, consumer protection and competitiveness in the credit industry.

<NP>Against this backdrop the IMF issued its 2008 Financial Sector Assessment Programme (FSAP) Report.⁹⁵ In respect of financial system regulation, the Report stated as follows:

<EXT>The financial sector regulatory framework is modern and generally effective. There is a need to strengthen supervision of conglomerates with a focus on risks that span more than one sector, and to further promote cooperation, consistency, and effectiveness among regulators.⁹⁶ </EXT>

<T>As a result the South African Treasury issued a report on financial sector regulation,⁹⁷ aimed at addressing the shortcomings identified by the IMF Report.⁹⁸ Principally the South African Treasury Report proposed the adoption of a Twin Peaks model of financial system

93 South African Reserve Bank, 'Bank Supervision', in *Regulation and Supervision*, South African Reserve Bank (undated) (accessed 17 August 2014), available at <https://www.resbank.co.za/RegulationAndSupervision/BankSupervision/Pages/BankSupervision-Home.aspx>.

94 National Credit Regulator, *About the NCR*, National Credit Regulator (2014) (accessed 17 August 2014), available at <http://www.ncr.org.za>. A statutory body created by the National Credit Act, No. 34 of 2005 (Republic of South Africa).

95 Kal Wajid, *supra*, note 70.

96 Kal Wajid, *supra*, note 70, at p. 1.

97 Republic of South Africa National Treasury, *supra*, note 71.

98 Kal Wajid, *supra*, note 70.

regulation.⁹⁹ The Treasury Report stated:

<EXT>The twin peaks approach is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority, and given South Africa’s historical neglect of market conduct regulation, a dedicated regulator responsible for consumer protection, and not automatically presumed to be subservient to prudential concerns, is probably the most appropriate way to address this issue . . . the existence of separate prudential and market conduct regulators may be a way of creating a system of checks and balances, thereby avoiding the vesting of too much power in the hands of a single agency . . . the flip side of creating checks and balances is the need to carefully define roles and responsibilities to avoid duplication of work and jurisdictional overlap . . . separation of prudential and market conduct regulation does not eliminate the possibility of conflict between them . . . consultation between the two bodies would lead to an acceptable compromise. But if not, some external means would need to be found to reconcile objectives. In South Africa, the formal way of resolving conflict will be through the Council of Financial Regulators.¹⁰⁰ </EXT>

99 Republic of South Africa National Treasury, *supra*, note 71, at p. 28.

100 *Ibid.*, at p. 28. Pursuant to advice provided by the writer to the South African Treasury in 2015, this has now be renamed the ‘Financial System Council of Regulators’. National Treasury, Republic of South Africa, ‘Financial Sector Regulation Bill, Comments Received on the Second Draft Bill Published by National Treasury for Comments on 11 December 2014 (Comment Period from 11 December 2014 – 02 March 2015)’, National Treasury, Republic of South Africa (2015), at p. 120. See also Chapter 5, Part 2, section 79 (1), Financial Sector Regulation Bill (2nd Draft) (21 August 2015) (Republic of South Africa).

<T>As a result, the South African Treasury has put forward a draft Financial Sector Regulation Bill which, as at time of writing, had recently been tabled in South Africa's National Parliament.¹⁰¹ The Bill makes provisions for the establishment of a Twin Peaks system in South Africa, and envisages the creation of a Financial System Council of Regulators,¹⁰² which will coordinate financial regulation, and the Financial Stability Oversight Committee,¹⁰³ which will coordinate financial stability issues and endeavour to mitigate risks to the financial system.

<A>III. AN ANALYSIS OF THE REGULATORY ENFORCEMENT

METHODOLOGY IN AUSTRALIA

<T>This section provides an analysis of risk-based financial regulation and its close cousins,¹⁰⁴ principles-based and outcomes-focused regulation. Because these are terms of art, not science, they cannot be defined, or indeed even separated, precisely. They do, however,

101 Tabled Bill no. B34-2015 (27 October 2015). National Treasury, Republic of South Africa, *Media Statement: Tabling of Financial Sector Regulation Bill to Give Effect to Twin Peaks Reform*, National Treasury, Republic of South Africa, Pretoria, ZA (27 October 2015).

102 Section 79, Financial Sector Regulation Bill (2nd Draft) (21 August 2015), which states: 'The Financial System Council of Regulators is hereby established. (2) The objective of the Financial System Council of Regulators is to facilitate co-operation and collaboration, and, where appropriate, consistency of action, between the institutions represented on the Financial System Council of Regulators by providing a forum for senior representatives of those institutions to discuss, and inform themselves about, matters of common interest.'

103 Section 5, Financial Sector Regulation Bill (11 December 2013) (Republic of South Africa).

104 J. Black, 'OFR: The Historical Context', Chapter 2, in *Outcomes-Focused Regulation: A Practical Guide*, eds A. Hopper QC and G. Treverton-Jones QC, 'Legal Handbooks', Law Society Publishing (2011), pp. 7–8.

share methodological and philosophical characteristics, which bear investigating.

<EXT>What lies under the labels is an agglomeration of regulatory styles and approaches, some of which are exhibited by some regulators, but not all of which are exhibited by all . . . a rough guide to a roughly drawn regulatory world and how it has evolved.¹⁰⁵ </EXT>

<T>Put simply, the hierarchy may be understood as follows: risk-based regulations are the tactics for addressing the strategy provided by outcomes-focused regulation: risk-based regulation is focused on outcomes and has, therefore, a natural affinity with, and folds into, an outcomes-focused paradigm.¹⁰⁶ Outcomes-focused strategies, in turn, address the grand strategy outlined by principles-based regulation.

A. Risk-Based Approach

<T>If in Australia Twin Peaks is the regulatory architecture, then the risk-based model¹⁰⁷ as used by APRA is the plumbing:

<EXT>. . . at APRA, we have always been strong proponents of risk-based supervision. It's inherent in our mission and values, and it's ingrained in our supervisory approach. It's in our DNA. For us, risk-based supervision is

105 *Ibid.*, at p. 8.

106 *Ibid.*, at p. 15.

107 *Ibid.*, at p. 9. For a history of risk-based financial regulation, see Black, *supra*, note 60, at p. 261. For a history of the development of different philosophical approaches to regulation, see Black, *supra*, note 106, at p. 8ff.

religion.¹⁰⁸ </EXT>

<T>While risk-based models of enforcement are not exclusive to Twin Peaks, some would argue that a risk-based model of enforcement is a natural adjunct to Twin Peaks. Put differently, you need not have Twin Peaks to use a risk-based model, but you may need a risk-based model to use Twin Peaks. This due to the fact that the safety and soundness regulator is, by its nature, concerned with combating systemic risk.

<NP>Risk-based prudential regulation focuses on activities that pose the greatest risk to the regulators' statutory obligations, as well as other key goals.¹⁰⁹ This approach has been adopted in the UK, the Netherlands, Canada, the United States, Hong Kong and Ireland, is recommended by the 2012 standards of the OECD's Financial Action Task Force and is proposed for adoption by the Joint Committee of European Supervisory Authorities.¹¹⁰ It is the method preferred by the World Bank, the IMF and the Basel Committee:¹¹¹

<EXT>As such, [this risk-based] approach is predicated on outcomes and thus has a natural affinity to [Outcomes Focused Regulation]: where conduct breaches a rule but does not have a substantive impact on, for example, consumer protection, the regulator will not act, or at least will not treat the issue as a matter of priority . . . a

108 D. Lewis, *Risk-Based Supervision: How Can We Do Better? An Australian Supervisory Perspective*, paper presented at the Toronto Centre Program on Supervisory Experiences in Implementing Global Banking Reforms, Toronto, Toronto, CA, edited by Toronto Centre, *Global Leadership in Financial Supervision* (19 June 2013), at p. 1.

109 Black, *supra*, note 106, at p. 9.

110 Black, *supra*, note 60, at pp. 261ff.

111 Black, *supra*, note 60, at p. 265.

focus [therefore] on risks not rules.¹¹² </EXT>

<EXT>Risk-based supervision is now seen as the hallmark of good regulation at the global level . . . IOSCO . . . recommends to supervisors that they take a ‘risk-based approach’^[113]. The revised Basel Core Principles for Banking Supervision issued in 2012 require supervisors to adopt effective risk-based systems^[114] . . . The Financial Stability Board (FSB)’s recommendations^[115] for the supervision of globally systemic financial institutions (GSIFIs) echoes the call for a risk-based approach.¹¹⁶ </EXT>

<T>There are a number of advantages to a risk-based approach.¹¹⁷ Most notably there is an acknowledgment that in a rules-based paradigm of financial system regulation, regulators are often over-burdened by rules – rules which cannot be enforced in every firm, for every

112 Black, *supra*, note 106, at p. 9.

113 See the International Organization of Securities Commissions (IOSCO), *Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries, Final Report*, IOSCO (December 2009), pp. 9ff.

114 See Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Bank for International Settlements (September 2012), p. 4 (§ 12).

115 See Financial Stability Board, ‘Increasing the Intensity and Effectiveness of SIFI Supervision’, in *Progress Report to the G20 Ministers and Governors*, Financial Stability Board (1 November 2012), p. 7.

116 Black, *supra*, note 60, at p. 264.

117 See B. Carruthers, “‘Objectives Based Regulation’: buzzword du jour?”, *Out of the Crooked Timber of Humanity, No Straight Thing Was Ever Made*, Blog (2 April 2008), available at <http://crookedtimber.org/2008/04/02/“objectives-based-regulation”-buzzword-du-jour/> (accessed 22 July 2015).

transaction, on every occasion. Selecting what to prioritise is, therefore, necessary and, according to Black,¹¹⁸ '[t]hese selections have always been made, but risk-based frameworks both render the fact of selection explicit and provide a framework of analysis in which they can be made':

<EXT>... pick important problems and fix them.¹¹⁹ </EXT>

<T>But pragmatic as this approach may sound, it leads to several unintended consequences which, in turn, undermine the overall efficacy of this regulatory paradigm. These include the following:

<BL>

- There is an assumption that regulators are smart enough to 'foresee the unforeseeable'.¹²⁰ Put differently, there is an assumption that regulators will know from where the next financial crisis will come and, consequently, correctly identify which types of risks and what forms of conduct to prioritise. But, as was seen during the GFC, this assumption is not always correct:

<EXT>... indeed with respect to the global financial crisis more broadly, assumptions that had been made as to how markets would react in particular scenarios proved significantly misplaced, with risk events that had been anticipated to occur

118 Black, *supra*, note 106, at p. 9.

119 M. K. Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Council for Excellence in Government, Brookings Institution Press (2000), 9.

120 What Black refers to as 'blind spots': Black, *supra*, note 34, at p. 23.

once in several lives of the universe . . . occurring every day.¹²¹ </EXT>

<BL contd>

- The model itself may incorrectly prioritise which risks to avoid, as distinct from a failure to identify the risk at all, and this was evident from the conclusions reached in the aftermath of the failure of HIH.¹²²
- There exists the potential for process-induced myopia, that is to say a focus on the process upon which risk-based regulation relies, without paying sufficient attention to issues that are outside the scope of what is covered by the process:

<EXT>If little scope is given in practice for those engaged in working within the framework to work outside it where they see the need, the framework will always be prey to events that those working within it were not given the room to say they had seen.¹²³ </EXT>

<BL contd>

To this end anecdotal evidence suggests that criticism of APRA and challenges to the organisation's prevailing orthodoxies are in danger of being met with hostility.¹²⁴

- There is, as a consequence, a lack of predictive certainty for the regulatees as to what forms of conduct will be sanctioned and what forms not.
- This in turn encourages a capricious regulatory environment, particularly where

121 J. Black, 'Learning from Regulatory Disasters', in *LSE Law, Society and Economy Working Papers*, no. 24/2014, London School of Economics and Political Science, (2014), 14.

122 Black, *supra*, note 34, at p. 23.

123 *Ibid.*, 23.

124 This anecdotal evidence is based upon the writer's tenure at APRA in late 2013 and informal discussions with colleagues.

different individuals in the regulators take different approaches or have different priorities.

- This fosters an unpredictable regulatory environment brought about by changes in the prevailing political climate.¹²⁵
- This in turn creates the potential for regulatees to encourage regulatory forbearance, either by arguing that the proposed sanctions pose a greater risk to the regulated entity and therefore the entire financial system than the misconduct itself; or¹²⁶ by creating the potential for regulatees to encourage forbearance, by arguing that similar conduct was expressly authorised by the regulator in the past (constituting, as it did then, an acceptable risk).
- What Llewellyn¹²⁷ refers to as the ‘Christmas tree effect’,¹²⁸ in which the regulator’s remit steadily increases – as perceptions of risk increase – with a wide array of ancillary functions, both to the point of over-burden and to the point of distraction from what should be core activities.
- Perceptions of risk are exactly that: perceptions. While APRA has attempted to create a methodology around the assessment of risk and to lessen the impact upon the

125 See Black, *supra*, note 106, at p.10. See also Black, *supra*, note 34, at pp. 24ff, where she asserts that politically, a failing bank, which may be acceptable to the regulator, may be unacceptable to those in the community who stand to lose their deposits. To this can be added political pressure from bank owners for the bank to be rescued, despite the regulator’s willingness to allow the bank to fail.

126 C. Binham and J. Guthrie, ‘FCA: On the Wrong Side of the Argument?’, *Financial Times*, 2 July 2015, 7:29 p.m.

127 Llewellyn, *supra*, note 24, at p. 23.

128 Citing M. Taylor and A. Fleming, *Integrated Financial Supervision: Lessons from Northern European Experience*, Policy Research Working Paper No. 2223, World Bank (September 1999), 13 (§ 2.24).

assessment of risk of individual perceptions, risk assessment is not and never will be as “rational” [or] as consistent in substance as its form suggests’.¹²⁹

B. Outcomes-Focused Regulation

<T>The risk-based approach followed by the Australian prudential regulator falls easily within a ‘regulation by objective’¹³⁰ paradigm, that is to say a paradigm the purpose of which is to ‘[achieve] particular and concrete outcomes’.¹³¹ This paradigm enjoys a number of advantages. These include the following:

<BL>

- Regulators can be more effective, with each having clear objectives (outcomes) that do not overlap.
- Regulators can, as a result, be more accountable and more focused¹³² on achieving those outcomes.
- It creates checks and balances between agencies, and their objectives.¹³³

129 Black, *supra*, note 34, at p. 24.

130 G. D. Killoren, ‘Comparative Analysis of Non-U.S. Bank Regulatory Reform and Banking Structure’, *Law and Business*, eds CCH Incorporated, Wolters Kluwer (2009), p. 10. See also H. M. Paulson Jr, R. K. Steel, D. G. Nason, K. Ayers, H. Etner, J. Foley III, G. Hughes, T. Hunt, K. Jaconi, C. Klingman, C. C. Ledoux, P. Nickoloff, J. Norton, P. Quinn, H. Schultheiss, M. Scott, J. Stoltzfoos, M. Ugoletti and R. Woodall, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, Department of the Treasury (March 2008).

131 B. Michael, S. Hak Goo and D. Wojcik, ‘Does Objectives-Based Financial Regulation Imply a Rethink of Legislatively Mandated Economic Regulation? The Case of Hong Kong and Twin Peaks Financial Regulation’, *Social Science Research Network* (12 November 2014), pp. 1–4ff.

132 See also Llewellyn, *supra*, note 24, at p. 26.

133 R. K. Abrams and M. W. Taylor, *Issues in the Unification of Financial Sector*

- It allows each regulator to create its own culture that best suits its objectives.
- It allows each regulator to acquire expertise specifically required to meet its objectives.¹³⁴

<T>As with a risk-based paradigm, so too an outcomes-focused approach has its shortcomings. These relate to the manner in which objectives are identified and prioritised.

As with a risk-based approach the danger remains that:

<BL>

- the regulator may identify the wrong objectives; or
- may initially identify the correct objectives but fail to adjust these in light of changed circumstances; or
- may find itself captured by industry with a concomitant contamination of its objectives; or
- become suborned by political masters in which the regulator's objectives are once again contaminated.

<T>Put differently, with flexibility in priorities come opportunities for a more nuanced approach to combating whatever problem the regulator is charged with preventing. But so too with flexibility come the pitfalls that arise wherever regulators are invested with discretion.¹³⁵

Supervision, IMF Working Paper, No. WP/00/213, International Monetary Fund (December 2000), 17.

134 C. Goodhart, P. Hartmann, D. T. Llewellyn, L. Rojas-Suarez and S. Weisbrod, 'The Institutional Structure of Financial Regulation', Chapter 8, in *Financial Regulation: Why, How and Where Now?*, Taylor & Francis (2013), 156–7.

135 Indeed A. Demirgüç-Kunt & E. Detragiache, *Basel Core Principles and Bank Soundness, Does Compliance Matter?*, Policy Research Working Paper, No. WPS5129,

C. Principles-Based Regulation

Both these approaches – objectives-based regulation and risk-based regulation – have as their overarching paradigm principles-based regulation, in that neither focus on systems and processes but on principles-based outcomes. Principles-based regulation, as an overarching paradigm too, has its deficiencies. A principles based model sets forth broad principles to be followed, as opposed to prescriptive, inflexible rules governing specific activities and requiring minimum standards of conduct:

<EXT> . . . means moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or principles to set the standards by which regulated firms must conduct business. The term ‘principles’ can be used simply to refer to general rules, or also to suggest that these rules are implicitly higher in the implicit or explicit hierarchy of norms than more detailed rules: they express the fundamental obligations that all should observe.¹³⁶ </EXT>

<EXT> So regulators, instead of focusing on prescribing the processes or actions that firms must take, should step back and define the outcomes that they require firms to achieve. Firms and their management will then be free to find the most efficient way

World Bank (November 2009), p. 5, find in certain circumstances an inverse correlation between regulator power and bank soundness: ‘ . . . power of supervisors to license banks and regulate market structure are associated with riskier banks’,

- 136 J. Black, *Principles Based Regulation: Risks, Challenges and Opportunities*, presentation by Julia Black on Principles Based Regulation to be followed by a Conversation with the Regulators, Sydney Supreme Courthouse (Banco Court), Sydney, NSW, Faculty of Economics and Business, University of Sydney (Wednesday 28 March 2007), 3.

of achieving the outcome required.¹³⁷ </EXT>

<T>In 2008 the Australian Law Reform Commission Report into privacy put forth the following statement by Curtis to explain the advantages of a principles based regulatory regime:

<EXT>By encouraging organisations to recognise the business advantages of [compliance] and regulating their behaviour accordingly . . . regulatory approach where a legislative framework is balanced by an emphasis on . . . self-regulation . . . inculcate the values and objectives . . . rather than just the superficial rules . . . organisations . . . will understand the ideas behind the laws – the principles – and will not become as confused by detailed . . . regulations.¹³⁸ </EXT>

<T>These sentiments, expressed in respect of privacy regulations, have been expressed in similar vein to support the supposed advantages of a principles-based regulatory regime for

137 Black, *supra*, note 138, at p. 5.

138 Curtis, quoted in D. Weisbrot (President), L. McCrimmon (Commissioner in charge), R. Croucher (Commissioner), Justice B. Collier (part-time Commissioner), Justice R. French (part-time Commissioner), Justice S. Kenny (part-time Commissioner) and Justice S. Kiefel (part-time Commissioner), ‘For Your Information: Australian Privacy Law and Practice (ALRC Report 108)’, No. 108, p. 1, Part A, Chapter 4, *Regulating Privacy*, Australian Law Reform Commission (12 August 2008), § 4.16. See further the Treasury, Australian Government, ‘Statement of Expectations – Australian Prudential Regulation Authority’, in *Statements of Expectations*, the Treasury, Australian Government (undated) (accessed 9 October 2015), available at http://www.treasury.gov.au/~media/Treasury/Policy%20Topics/Public%20Policy%20and%20Government/Statements%20of%20Expectations/Downloads/PDF/APRA_State%20ment_of_expectations.ashx, p. 2.

the financial system.¹³⁹ There is, however, a difference between information privacy regulations and financial system regulations, and one so crucial that it undermines the supposed advantages of the principles-based model: financial system regulations almost always contain an opportunity cost to the regulatee in addition to the mere compliance cost.¹⁴⁰ Put differently, in the financial system the costs of full regulatory compliance are potentially significantly higher¹⁴¹ and the degree of convenience to the bank for non-compliance significantly greater.¹⁴² In this regard it is questionable whether Black is correct when she asserts that: '[r]egulatees have to take more responsibility for ensuring that they are achieving the right outcomes, not just going through the right processes'¹⁴³ as this does not

139 Black, *supra*, note 138, at pp. 2–7ff.

140 For more on the special nature of financial services regulation, and in particular the distinction that such services are incomplete contracts, relational rather than transactional, see D. T. Llewellyn, 'Trust and Confidence in Financial Services: A Strategic Challenge', 13 (4) *Journal of Financial Regulation and Compliance* (2005), 334, 339, 340–1; S. Bhati, 'An Analysis of the Financial Services Regulations of Australia', 4 (2) *International Review of Business Research Papers* (March 2008), 14ff. Cf. Llewellyn, *supra*, note 24, at p. 5, who argues that compliance has a cost, but not a price. As a result consumers will, he argues, regard regulation as a free good and over-demand it, thus creating an inexorable tendency towards over-regulation. This view, however, fails to adequately account for instances where industry pressure has succeeded in rolling back regulation. See A. E. Wilmarth Jr, 'Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street', 81 (4/4) *University of Cincinnati Law Review* (2013).

141 For more on this from the perspective of risk methodology and game theory, and the so-called 'prisoner's dilemma', or what in economics is referred to as the 'tragedy of the commons', see P. McConnell, *Systemic Operational Risk: Theory, Case Studies and Regulation*, Risk Books (2015), 404–5.

142 See S. L. Schwarcz, 'Systemic Risk', 97 (1) *Georgetown Law Journal* (2008), 206, quoted in McConnell, *supra*, note 143, at pp. 50–1.

143 Black, *supra*, note 106, at p. 11.

adequately take account of the compulsion, inherent in financial regulation, for regulatees to constantly look for ways to lessen the impact of the regulations to which they ought to adhere, not just including but especially in respect of outcomes.

<NP>Add to this the heady mixture created by a regulatory paradigm that is more one of managing conduct than enforcing discipline,¹⁴⁴ is located within an overall strategy that seeks, at least initially, to be cooperative and collegial as opposed to confrontational,¹⁴⁵ and seeks by negotiated settlement to define outcomes more general than specific, then it is no wonder that goals shift and outcomes become malleable:

<EXT>A principles-based approach does not work with individuals who have no principles.¹⁴⁶ </EXT>

<T>Indeed, one could argue that if it is outcomes that are set as benchmarks, as opposed to processes,¹⁴⁷ then all that is required in order to encourage regulators to forebear is to re-negotiate the outcomes, a clearer and more straightforward objective than re-negotiating a myriad of complex processes.

<NP>A further important factor determining the efficacy of regulators is the political

144 Black, *supra*, note 138, at pp. 19–20.

145 I. MacNeil, ‘Enforcement and Sanctioning’, Chapter 10 in *The Oxford Handbook of Financial Regulation*, eds N. Moloney, E. Ferran and J. Payne, in ‘Part III, Delivering Outcomes and Regulatory Techniques’, 1st edn, Oxford University Press (August 2015), 285; Schmulow, *supra*, note 2, pp. 21ff.

146 Hector Sants, Chief Executive Officer, Financial Services Authority. Quoted in L. Elliott and J. Treanor, ‘Revealed: Bank of England Disarray in the Face of Financial Crisis’, *Guardian* (7 January 2015).

147 Weisbrot (President) et al., *supra*, note 140, at § 4.6.

climate in which they operate.¹⁴⁸ This will affect the robustness of enforcement and may extend to the vigour with which principles are at first determined and later adjusted. The degree to which the United States' Congress is beholden to Wall Street¹⁴⁹ and the pushback against the FSA¹⁵⁰ in the UK are instructive in this respect.

<EXT> And fashions, even in regulation, change. In the UK, Antony Jenkins, the patron saint of conduct risk, has just been unceremoniously dumped as CEO of Barclays Bank, ostensibly for concentrating on managing the bank's toxic conduct rather than making profits. The conduct risk pendulum may already be beginning to

148 The very decision to regulate is political and the form and extent thereof ideological. B. Sheehy and D. Feaver, 'Designing Effective Regulation: A Normative Theory', 38 (1) *University of New South Wales Law Journal* (1 January 2015), 394, and at p. 418: 'Although the decision is ultimately made by a political body, such as the executive or legislature, the selection choice is frequently subverted at much earlier stages in the policy-making process. Ideology, political influence and even an adherence to intellectual fashion by advisers and experts all influence the decision.'

149 A. E. Wilmarth Jr, *supra*, note 142; L. R. Wray, 'Setting the Record Straight One More Time: BofA's Rebecca Mairone Fined \$1 Million; BofA Must Pay \$1.3 Billion', *New Economic Perspectives* (2 August 2014), available at <http://neweconomicperspectives.org/2014/08/setting-record-straight-one-time-bofas-rebecca-mairone-fined-1million-bofa-must-pay-1-3billion.html> (accessed 26 June 2015); E. Wyatt, 'Promises Made, Then Broken, By Firms in S.E.C. Fraud Cases', *New York Times*, 8 November 2011.

150 Anonymous, 'Britain's Bank-Basher-in-Chief Is Toppled', *The Economist*, 17 July 2015, available at <http://www.economist.com/news/britain/21659145-ousting-citys-fiercest-watchdog-suggests-more-emollient-political-mood-britains>; C. Binham and J. Guthrie, *supra*, note 128; T. Wallace, 'FCA Chief Martin Wheatley Ousted by George Osborne', *Telegraph*, Friday, 17 July 2015, available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11746504/Coup-in-the-City-as-George-Osborne-ousts-UKs-top-financial-regulator-Martin-Wheatley.html>.

swing back and the current fashion for piousness may be fading.¹⁵¹ </EXT>

<EXT>At first glance, Wall Street's ability to block Dodd-Frank's implementation seems surprising. After all, public outrage over Wall Street's role in the global financial crisis impelled Congress to pass Dodd-Frank in 2010 despite the financial industry's intense opposition. Moreover, scandals at systemically important financial institutions (SIFIs) have continued to tarnish Wall Street's reputation since Dodd-Frank's enactment. However, as the general public's focus on the financial crisis has waned – due in large part to massive governmental support that saved Wall Street – the momentum for meaningful financial reform has faded.¹⁵² </EXT>

<T>Similarly, in Australia there are examples of what in the UK came to be known as the 'light touch'.¹⁵³ For example the regulators follow policies set forth under Basel II in which banks are permitted to determine their own internal risk ratings.¹⁵⁴ Put differently, IRB¹⁵⁵ models, as they are known, permit a bank to determine whether it is complying with overall prudential principles, a model which gives rise to a dangerous conflict of interest¹⁵⁶ and one

151 McConnell, *supra*, note 30. See also K. C. Engel and P. A. McCoy, 'Turning a Blind Eye: Wall Street Finance of Predatory Lending', 75 (4) *Fordham Law Review* (March 2007), 2040.

152 Wilmarth Jr, *supra*, note 142, at p. 1283.

153 See, for example, J. Treanor, 'Farewell to the FSA – and the Bleak Legacy of the Light-touch Regulator', *Guardian/ Observer* (24 March 2013).

154 See, for example, Basel Committee on Banking Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions*, Bank for International Settlements (July 2005).

155 Internal ratings-based.

156 An example of what, according to Sheehy et al., is a form of 'internal incoherence'. Sheehy and Feaver, *supra*, note 150, at p. 417.

that is now being dismantled.¹⁵⁷

<NP>So while risk-based supervision, within a framework of outcomes-focused and principles-based regulatory strategies, has advantages – especially as regards the prioritising of risks in an environment where risks and potential risks are potentially limitless – they are nonetheless vulnerable to institutional inadequacies, incorrect priorities, political interference, industry pressure and a failure to foresee the unforeseeable. They lead to a capricious and unpredictable regulatory environment in which priorities are malleable and regulators are susceptible to capture.¹⁵⁸

157 D. Henry and E. Stephenson, ‘Fed May Shun Global Risk Rules Banks Spent Billions to Meet’, *Reuters* (US edn), Wednesday, 4 June 2014, 9:16 p.m. EDT), available at <http://www.reuters.com/article/2014/06/05/us-banks-regulations-insight-idUSKBN0EF09U20140605>.

158 For a balanced view on this issue as it presents in the United States, see L. G. Baxter, ‘Capture Nuances in Financial Regulation’, 47 (3) *Wake Forest Law Review* (Fall, 2012). Cf. Wilmarth Jr, *supra*, note 142. For the position in Australia see P. McConnell, ‘Debunking the Myth of Our “Well-Regulated” Banks’, *The Conversation*, 13 September 2012, 6.38 a.m. AEST), available at <https://theconversation.com/debunking-the-myth-of-our-well-regulated-banks-9333>, p. 4. For more on the susceptibility of fragmented agencies to capture, see J. K. Gakeri, ‘Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm for Kenya’, 1 (16) *International Journal of Humanities and Social Science* (November 2011), 167–8; and on the advantages of the functional approach to resisting capture, see Working Group on Financial Supervision, ‘The Structure of Financial Supervision. Approaches and Challenges in a Global Marketplace’, in *Special Report*, Group of Thirty, Consultative Group on International Economic and Monetary Affairs (2008), p. 35. On accountability as a bulwark against capture, see R. J. Herring and J. Carmassi, ‘The Structure of Cross-Sector Financial Supervision’, 17 (1) *Financial Markets, Institutions and Instruments* (February 2008), 24.

<A>IV. AUSTRALIA AND SOUTH AFRICA, DIFFERENCES AND SIMILARITIES

<T>The most noticeable difference between the Australian approach and the proposed South African model is that the Australian Prudential Regulator is an independent entity,¹⁵⁹ whereas the South African proposal is for the Prudential Authority to be a division of the South African Reserve Bank,¹⁶⁰ albeit as a separate juristic person.¹⁶¹

<NP>While the Australian model provides a high degree of statutory independence to the system stability regulator,¹⁶² APRA, it is to a degree answerable to the Treasurer,¹⁶³ and both APRA¹⁶⁴ and ASIC¹⁶⁵ to the Federal Parliament by way of submission of Annual Reports. Taylor envisages either ministerial oversight or Parliamentary oversight¹⁶⁶ in his model. The South African Bill envisages accountability to the National Treasury (and ultimately Parliament) through the Financial Stability Oversight Committee¹⁶⁷ and the annual

159 Established under section 7, Australian Prudential Regulation Authority Act (Cth), No. 50 of 1998, as a body corporate, section 13, *ibid.*

160 Section 24(1), (3) and (4) read with the objects and purport of section 33(2), Financial Sector Regulation Bill, 11 December 2013.

161 Section 11 (2), Financial Sector Regulation Bill, 11 December 2013.

162 Section 11, Australian Prudential Regulation Authority Act (Cth), No. 50 of 1998.

163 Section 12, *ibid.*; the Treasury, Australian Government, *Statement of Expectations for the Australian Prudential Regulation Authority*, the Treasury, Commonwealth Government of Australia (20 February 2007), 4–5.

164 Section 59, Australian Prudential Regulation Authority Act (Cth), No. 50 of 1998.

165 Section 136, Australian Securities and Investments Commission Act (Cth), No. 51 of 2001.

166 Taylor, *supra*, note 6, p. 11.

167 The Financial Stability Oversight Committee gives the SARB (of which the prudential regulator would be, it is envisaged, a department) ultimate responsibility for financial stability: section 4, Financial Sector Regulation Bill, 11 December 2013, and would be required to report to the Minister any threats to system stability: section 5(2)(d), *ibid.*, and which would, twice a year, be required to report to the Minister on the overall state

reporting requirements.¹⁶⁸ Consequently, this comports with Taylor's original recommendation,¹⁶⁹ which he claims is more likely to negate the politicisation of the regulator, than would an arrangement that requires the regulator to be responsible only to Parliament. The internal logic of this argument is, however, difficult to discern. It could just as easily be argued that responsibility to Parliament may ameliorate pressure from the Treasury, and may serve to countervail the possibility of regulatory capture.

<NP> While there is no definitive answer to the question of whether it is better to locate the prudential regulator within the NCB, or outside, the balance of probabilities favours the latter.¹⁷⁰

<A> V. CONCLUSION

<T> If South Africa continues to develop and succeeds in lifting more South Africans out of poverty, ever greater calls will be made on the private sector to provide a wide variety of savings and investment products and self-funded social insurance. An agency dedicated to market conduct and consumer protection will, therefore, become ever more necessary.

<NP> A bifurcated system, it is argued, is preferable. One entity will be responsible for system stability, including ongoing prudential regulatory enforcement and development of

of system stability: section 9, *ibid.*

168 Part 7, section 39(1)(a), *ibid.*, which requires the regulatory authorities to report within 90 days of the end of the financial year, and section 39(1)(b) which requires the Minister to table the regulatory authorities' reports within 30 days to the National Assembly (Parliament of the Republic of South Africa). Section 39(3), *ibid.*, requires the regulatory authorities to submit to the Minister a report on any other matter that may affect system stability, public finances or any other matter deemed necessary, and must do so on an ad hoc basis and of its own initiative.

169 Taylor, *supra*, note 6, at p. 11.

170 See Schmulow, *supra*, note 1, at pp. 51ff.

all financially significant firms, including banks, insurers or a combination of the two, on a single and consolidated basis. This will prove even more important in the future, as the lines between banks, merchant banks and insurers continue to be blurred, and as the scale of interconnectedness between financial firms continues apace, particularly in the OTC¹⁷¹ derivatives market, in which banks and securities firms are the primary dealers. The size of the OTC market, the global notional value of which was a staggering US\$710 trillion as at December 2013,¹⁷² represents the clearest indication of the potential for interconnectedness, and poses a significant threat to any financial system through contagion, both endogenous and exogenous. Only a whole-of-entity, consolidated group approach can hope to address this interconnectedness. So, while South Africa came through the GFC relatively unscathed, due mainly to the conservative nature of its banking system,¹⁷³ the experience gained from the GFC was that increasingly esoteric products, created by securities firms beyond the purview of institutional or functional regulators, created a blind spot for regulators in the USA and Europe,¹⁷⁴ one that ultimately had catastrophic economic consequences.

<NP>The second entity will be responsible for market conduct and consumer protection. It is argued such a system would be more likely to resolve fragmentation, provide clarity of ambit, be more cost-effective due to rulebook simplification and improve accountability – more likely, but not definitely, as the recent failings of ASIC in Australia

171 Over the counter.

172 Bank for International Settlements, ‘International Banking and Financial Market Developments’, *BIS Quarterly Review*, Bank for International Settlements (September 2014), Table 19, A 141.

173 D. Cavvadas, ‘South Africa: A Sophisticated Securities and M&A Regime’, *Securities and Mergers and Acquisitions Newsletter*, Q1 (April 2010), available at <http://www.fasken.com/en/south-africa-sophisticated-securities-ma-regime/> (accessed 21 September 2014).

174 Working Group on Financial Supervision, *supra*, note 160, at p. 20.

have demonstrated.¹⁷⁵ If the consumer protection and market conduct regulator does prove effective, then advantages accrue to consumers for a ‘one-stop shop’¹⁷⁶ for complaints against regulated firms.

<NP>Ultimately, of course, the success of a Twin Peaks regime in South Africa will depend upon the efficacy of enforcement – *governance* – and this in turn will depend upon the goals that are set – *the principles* – and on how those goals are pursued. That in turn will depend upon market intelligence – *the risks* – along with the independence and the capacity of the regulators to pursue corrective action free of interference or industry capture, coordination between the peaks, the resources – physical and human – which the regulators bring to bear, and their willingness, if need be, to take on vested and powerful interests.

<NP>If successful, Twin Peaks will help lay the foundations for a dynamic financial sector, one that already plays a significant role – an excessive role according to some¹⁷⁷ – in South Africa’s economy. If Twin Peaks fails, and fails under the wrong circumstances, such

175 For a detailed account of the financial advice scandals in Australia, and the failures of ASIC, see Schmulow, *supra*, note 1, at pp. 47ff.; Senator M. Bishop (Chair), Senator D. Bushby (Deputy Chair), Senator S. Dastyari, Senator L. Pratt, Senator J. Williams, Senator N. Xenophon, Senator D. Fawcett and Senator P. Whish-Wilson, *Performance of the Australian Securities and Investments Commission*, Parliament of Australia, the Senate (June 2014); Ferguson, *supra*, note 30; A. Ferguson and D. Masters, *Banking Bad*, in ‘Four Corners’, Audiovisual Material, Documentary, Sydney, NSW, Australian Broadcasting Corporation (5 May 2014); J. Lee, C. Houston and C. Vedelago, ‘CBA Customers Lose Homes Amid Huge Fraud Claim’, *The Age* (29 May 2014); A. Ferguson and B. Butler, ‘Commonwealth Bank Facing Royal Commission Call after Senate Financial Planning Inquiry’, *Sydney Morning Herald*, Business Day edn, 26 June 2014.

176 Taylor, *supra*, note 6, at p. 11.

177 ‘Dangerously over-financialised’, and contributing 28 per cent of South Africa’s GDP. B. Brkic, ‘Analysis: Is South Africa Over-banked?’, *Daily Maverick*, 23 February 2010, 12:57 (South Africa)).

as another global financial crisis, the results will be catastrophic.

<A>ACKNOWLEDGMENTS

<T>This research was conducted under the leadership of Professor Andrew Godwin of the Melbourne Law School and financed in major part thanks to financial support from the Centre for International Finance and Regulation (CIFR) in Sydney, Australia. That support, and support in numerous other forms from CIFR, is hereby acknowledged with gratitude. Helpful comments and suggestions from Dr Michael Taylor, the father of Twin Peaks, Professor Jeffrey Carmichael, Foundation Chair of the Australian Prudential Regulation Authority, Professor David Llewellyn, Chair of the Banking Stakeholder Group of the European Banking Authority, and Dr Patrick McConnell are acknowledged with great appreciation, as is the guidance and friendship of Professor Andrew Godwin.
