

Role of industry standards in a principle-based regulatory regime

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A high-powered industry panel was convened at the 2007 IFSA conference to discuss the role that industry standards play in defining and regulating the conduct expected of financial services industry participants.

Main points

- Industry standards provide content relating to the quality of actions or behaviour expected of industry members.
- Industry standards usually represent a collective industry viewpoint and create expectations from both industry participants and their stakeholders, who may view the standards as a series of promises made to them.
- Industry standards are ideal in addressing specific issues. They promote trust, pride and integrity and are good for business.
- Yet 'breaching' an industry standard can mean many different things, depending on whether the standard is seen as aspirational or mandatory in nature.
- In terms of their role in a principle-based regulatory regime, industry standards are good at filling gaps and creating an industry benchmark for use in the regulatory process.
- A combination of principles, standards and laws therefore offers a comprehensive and effective control framework for regulating any industry.
- But, where elements overlap or stray in their language, uncertainty and confusion may arise.
- Further tightening of the law or the standard is the usual, but counter-productive, remedy.

IFSA panel

The panel was comprised of Michael Bargholz, Chief Executive Officer, AllianceBernstein Australia Ltd; John van Geldermalsen, St James Ethics Centre; and Malcolm Rogers, Head of Regulatory Policy, the Australian Securities and Investments Commission (ASIC).

The panel discussed a range of issues related to industry standards, which for the purposes of this article have been grouped under the following headings:

- What is the difference between principles and standards?
- What is the purpose of industry standards?
- How do the standards link to the current regulation of the financial services industry?
- What are the common mistakes and misconceptions about the role and application of industry standards?

This article will consider the matters discussed by the panel under each of these headings.

What is the difference between principles and standards?

In drawing a distinction between principles and standards, Michael Bargholz referred to the Macquarie dictionary definition of the term 'principle', meaning '... a basic, primary, or general truth, a basic belief, guiding rules of right behaviour'.

He argued that values and principles should define rather than constrain behaviour and that good ethics have value in and of themselves.

John van Geldermalsen argued that principles can sometimes be thin in content, but broad in reach. As a result, principles often require a context in addition to thought before they can be applied to real-life situations. The way in which principles will be applied and the actions that will arise as a result will also depend on the ethical position of each individual. However, because they offer such freedom of action, within broad boundaries, they can sometimes be difficult to 'breach'.

He defined standards, on the other hand, as providing content relating to the quality of the actions or behaviour of the individual or group. He argued that standards were subsidiary to principles, and are often expressed positively to give meaning or context to how the principle should be applied.

What is the purpose of industry standards?

Malcolm Rogers argued that industry standards usually represent a collective industry viewpoint and create expectations from both industry participants and their stakeholders, who may view the standards as a series of promises made to them.

In his view, their purpose is to act as high-level beacons or cultural reference points to industry best practice, which, in turn, assists in preserving industry reputation. If done well, industry standards will enable consumers to compare between participants. Industry standards should also create a benchmark for conduct and foster competition in the industry around that benchmark.

Michael Bargholz agreed that industry standards are ideal in addressing specific industry issues. He argued that they also promote trust, pride and integrity, and are good for business.

John van Geldermalsen viewed their role using a co-regulatory theme — the law creates a framework to weed out bad apples and industry should define how it will conduct itself in all other circumstances, using a series of principles or values which are then further defined in a set of standards.

How do the standards link to the current regulation of the financial services industry?

Malcolm Rogers argued that for regulators, industry standards are a driver for industry to move from basic compliance to best practice. They can assist an industry to move in a particular direction voluntarily, rather than waiting

for the regulator to make that move using legislation and regulation. Rogers argued, therefore, that the use of industry standards in this context is preferable to the coercive powers of the state.

Standards were also considered to have a role in filling the gaps left by the law. For example, the *Corporations Act 2001* (Cth) does not describe everything that can occur in the provision of financial services.

In addition, in determining whether a person is complying with the *Corporations Act*, a regulator will consider the benchmark set by the industry standard for use in the regulatory process.

Rogers also felt that industry standards had a role in dealing with clearly identifiable problems. He gave the example of work completed by ASIC, two years ago, on consumer calculators from product issuers (all seriously varied in their calculations for the same investment). ASIC wanted to articulate a high-level standard which industry should move towards. IFSA now has a policy on this matter.

John van Geldermalsen argued that a combination of principles, standards and laws offers a comprehensive and effective control framework for regulating any industry. However, he cautioned that where elements overlap or stray in their language, uncertainty and confusion may arise and further tightening of the law or the standard is the usual, but counter-productive, remedy.

The conclusion reached was that industry standards can assist in regulating the conduct of industry participants.

IFSA, for example, has a Code of Ethics, 13 Standards and more than 20 Guidance Notes, which then define and clarify the values or principles outlined in the Code. The Standards cover an evolving list of industry issues, as outlined by Michael Bargholz in his presentation, including:

- equity trusts;
- operational capability;
- product performance: calculation of returns;
- references to the IFSA logo;
- scheme pricing;
- valuation of scheme assets and liabilities;
- presentation of past performance information and visual promotions;
- genetic testing policy;
- proxy voting;

- alternative forms of remuneration;
- rebates and related payments;
- family medical history policy; and
- incorrect pricing of scheme units — correction and compensation.

What are the common mistakes and misconceptions about the role and application of industry standards?

John van Geldermalsen outlined that industry standards are often divided into different levels as follows:

- minimum standards — which provide concrete guidance regarding the boundaries of the broad principles and act like laws;
- acceptable standards — which encourage acting in a certain way and are not therefore enforceable; and
- high standards — which are aspirational in nature and purport to define best practice.

In his view:

- high standards will often not be met;
 - minimum standards *must* be met; and
 - acceptable standards *should* be met.
- Problems can arise from:
- a lack of clarity about what constitutes ethical or unethical behaviour in the context of the standard itself; and because
 - standards are often non-specific and do not tell you what to do.

John van Geldermalsen gave examples of IFSA Standards, which he argued were hard to interpret due to the non-specific language used and their broad application, as follows:

IFSA members *will strive to ensure* people acting on their behalf are properly trained and perform their duties and obligations to a *high standard of professionalism*.

IFSA members should actively *promote and nurture* ethical and transparent decision-making behaviours and practices both within the industry and their respective organisations.

In his view, one of the difficulties with best practice standards, such as the examples just given, is that despite their aspirational nature, they are often written as laws or as a mandatory requirement. Note the use of the word ‘will’ in the first example. Yet aspirational standards by their nature espouse values that are difficult to interpret and define to an exact degree. This means they can be open to

many interpretations, particularly in terms of how they are implemented and enforced in different organisations. Note the use of the words ‘promote and nurture’ in the second example.

In addition, breaching these standards can mean many different things, depending on the level of standard being applied.

All of these matters can lead to selective compliance by industry participants and result in a discredit to self-regulatory systems. ●

Practical implications

There are a number of practical implications arising from this article for industry participants when interpreting and implementing industry standards into a business framework.

- Industry standards usually represent a collective industry viewpoint and create expectations from both industry participants and their stakeholders who may view the standards as a series of promises made to them. Remember, therefore, to consult stakeholder groups about their interpretation of the conduct expected from the standard and cross-reference this against your own interpretation.
- Industry standards are ideal in addressing specific issues. They also promote trust, pride and integrity, and are good for business. Accordingly, they have many benefits. Don’t think of them as an additional compliance burden, as this view will permeate the perceptions of staff and lead to non-compliance.
- Breaching an industry standard can mean many different things, depending on whether the standard is seen as aspirational or mandatory in nature. Ensure your organisation has a clear view of what the standard means in the context of your business, how it ties to existing organisational values and the level of conduct expected of staff as a result.



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