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The Public Bill Committee for the Financial Services Bill 2009
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BY EMAIL ONLY

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Dear Sirs

Financial Services Bill 2009 (the "Bill")

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introduction

We set out below our comments on a number of provisions in the Bill. It is a common theme that many provisions amount to a transfer of fundamental legislative responsibilities from Parliament directly to the Financial Services Authority ("**FSA**") without the intervening constitutional protections provided by Parliamentary scrutiny of

delegated legislation. It is of course the case that the FSA currently has extensive rule making powers, but the exercise of these powers is subject to a number of legislative constraints within the Financial Services & Markets Act 2000 (the "**FSMA**"), which, as we note below, appear to be missing from the Bill. As drafted the FSA has extraordinarily wide rule making powers (and in some cases is required rather than empowered to make rules) without much, if any, direction within the statute as to any limitations on its use of them. This will result in an increasing lack of predictability in dealing with the regulator. In our view the Bill represents the high water mark of an increasing tendency to eliminate substance from primary legislation and to confer executive power without proper Parliamentary scrutiny at the level of either primary or secondary legislation. The specific issues we raise below in this context are in our view particularly serious and we very much hope that these defects are amended before the Bill becomes law.

Section 1. Objectives, scope and rule-making powers

The Financial Stability Objective - Clause 5

We understand the Government's policy reasons for giving the FSA a responsibility for contributing to financial stability. However it seems to us that the "financial stability objective" as framed is undesirably wide, given particularly that it is framed as a free standing objective, with no express relationship with any of the FSA's other objectives. Taken literally, it appears to give the FSA responsibilities which seem more appropriate for a government department than a regulator. We suggest that it would be helpful to include some qualifications to the objective to put it into context: for example, the existing "reduction of financial crime objective" (Section 6 of the FSMA requires the FSA to "have regard" to various factors, and these, among other things, help to clarify the intended ambit of the objective. As we understand it the Government's main concern is to ensure that the FSA takes account of the systemic risk posed by common patterns of behaviour by, and relationships between, regulated firms and perhaps this could be spelt out. At the very least we suggest that the FSA should be required to publish a policy statement or similar document explaining how it understands the objective and the types of action it envisages taking to further it. This would be consistent with the approach adopted in relation to the special resolution objectives in Part 1 of the Banking Act 2009.

It is important to clarify the scope of the objective because the FSA is to be allowed to exercise various powers solely on the basis that this is desirable in order to achieve it: see on clause 7 below.

Meeting the FSA's regulatory objectives - Clause 7

In the FSMA in its present form, the FSA's powers:

(a) to refuse an application by an authorised person to vary or cancel its Part IV Permission (Section 44 of the FSMA);

(b) to vary or cancel Part IV Permissions on its own initiative (Section 45);

(c) to make rules (Section 138); and

(d) to exercise its power of intervention in relation to EEA firms which "passport" into the UK (Section 194),

are qualified by reference to protecting the interests of "consumers" (i.e., broadly, persons who use, or contemplate the use of, the services of an authorised person or have an interest in such use). This seems to us to apply a sensible

limit to the exercise of the powers concerned. In effect it is unlikely that the power can be exercised unless it can be shown that the behaviour of the authorised person concerned is, or is likely to, cause some kind of harm to such consumers.

Clause 7 would amend these provisions so that the FSA can exercise any of these powers if the action concerned is desirable in order to meet any of the FSA's regulatory objectives (including the financial stability objective). This new test, when coupled with the uncertain ambit of the financial stability objective, seems to us unsatisfactorily vague. It appears to allow the FSA to vary a firm's Part IV Permission, or to close it down, simply because this is consistent with the FSA's view of what contributes to the protection and enhancement of the stability of the UK financial system. So, for example, if a bank becomes "too big to fail", it would apparently be possible for the FSA to cancel its Permissions simply for this reason. If the FSA is to have such powers we suggest that legislation needs to include a great deal more protection against their misuse. At minimum we suggest that the policy statement suggested above should include an indication of the circumstances in which the FSA would expect to exercise the powers concerned.

The amendments in clause 7(3)(b) and 7(5)(b) provide that in this context "it does not matter whether there is a relationship between the authorised person and the persons whose interests will be protected by the exercise of the power under [the relevant Section]". While we can see that it may be appropriate for the FSA to exercise its powers against a firm to protect people who are not the firm's clients, or who are indirectly affected by its activities, the provision as drafted seems excessively wide. It appears to allow the FSA to adopt what one might call the "Admiral Byng" approach to regulation: it is immaterial whether the firm against whom it takes action is doing any harm to anyone as long as the effect of the action will be a deterrent to others. It seems to us a matter of fundamental fairness that firms should only be called to account for their own shortcomings and we suggest that the provisions are amended or deleted. (We acknowledge that a similar provision was recently introduced into Section 45 of the FSMA by the Banking Act 2009, but it is nevertheless unsatisfactory, and we suggest that this is a good opportunity to reconsider the point.)

Performance of Controlled Function without approval - Clause 16

Clause 16 would enable the FSA to impose a penalty on an individual who performs a "controlled function" (i.e., a function in relation to an authorised person of a type specified by the FSA) without having approval unless there are reasonable grounds for the FSA to be satisfied that the individual:

(a) did not know;

(b) could not reasonably be expected to have known;

that he was performing a controlled function without approval.

We appreciate that there may be circumstances where an individual connives with an authorised person to carry out a controlled function without approval, for example, where he or she is aware that there will be difficulty in obtaining it. However it seems to us that the proposed sanction is framed far too widely. What functions are, and are not controlled, is a complex matter and may depend on the structure of the particular firm (or indeed that of a group of which it is part); and it is only the firm that can apply for the individual to be approved. It seems to us that the burden should be on the firm, and not the individual, to get this right, and that the individual should be entitled to assume that it has done so. On this basis the qualifications by reference to the individual's knowledge or expected knowledge are quite inadequate: the test of what the individual could "reasonably be expected to have known" is essentially circular, since what is reasonable depends on whether the individual was under a responsibility to check.

We suggest that the Government's objective could be more acceptably achieved by limiting the penalty to cases where the individual carries on a function in circumstances where the individual knows that (1) the function is a controlled function and (2) no approval has been obtained.

Section 2. Remuneration of executives of authorised persons

Remuneration of executives – Clauses 9 to 11

In the evidence presented by the CLLS's representatives during the Public Bill Committee's session on 10 December 2009, we drew attention to particular issues relating to the provisions concerning FSA rules providing for the voiding of remuneration provisions and the clawback of benefits. In our view these are obscure and will be of uncertain application in practice. Key questions include: Who is to decide whether a contract provision falls to be voided under the rules (and are there to be any opportunities for the contracting parties to be heard on the issue before an independent tribunal)? How can an FSA-made provision override contracts governed by foreign law, or retrospectively override provisions entered into in good faith before its rules come into force? Exactly how, and by whom, will benefits be recouped, and how will they be recouped from an overseas jurisdiction? Although these are fundamental issues, they are not the only ones raised by this part of the Bill.

Remuneration reports

The class(es) of individuals who are to be subject to the Bill's provisions on remuneration reports is equally obscure – in part because of the lack of draft regulations from HM Treasury. The scope of "relevant executives" is uncertain, and potentially captures (through the wording of paragraph (4)(a)) individuals employed by third party contractors over whom an authorised person has no legitimate say as to their individual remuneration structure, such as an accountant in an audit firm or a solicitor in a law firm. The usage of the term "officer" is also obscure – the definition in clause 10(7) is drafted in such a way as to exclude the typical usage in a company, leaving uncertain (given the Explanatory Notes) the degree to which it is intended to capture non-executive directors of unquoted companies.

Although it is not clear on the face of clauses 9 and 10, the operation of clause 37 of the Bill would suggest that HM Treasury's regulations will apply only to the United Kingdom. For an authorised person that is not a United Kingdom firm and has no physical presence here (e.g. by exercising "passporting rights" to carry on cross-border services with United Kingdom residents under one or more single market directives) its scope of application is unclear, particularly in the light of the relevant allocation of responsibilities under the single market directives. On their face, these clauses are extra-territorial in scope and are directly contrary to the United Kingdom's EU obligations.

FSA rule-making

The Bill, unlike the FSMA, imposes specific rule-making obligations on the FSA. Irrespective of the merits of imposing a duty at all, there are a number of legal issues that arise. The interaction of this obligation with the FSA's existing FSMA obligations on rule-making (including obligations on consultation, cost benefit analysis) is unclear. On the face of clause 11(1) the FSA will be required to make remuneration rules for <u>every</u> authorised person. It is not clear that the bracketed wording actually has the effect contemplated in the Explanatory Notes (i.e. the FSA can choose whether it is for all or for a particular class of authorised person). Nor is it clear that the FSA can make different provisions (including none) for different classes of authorised person (e.g. IFAs compared with banks), as one would expect in the light of the FSA's obligations under FSMA section 2, for example to have regard to

competition and proportionality, and its obligations to take account of consultation responses and its cost benefit analyses. This issue is not confined to clause 11 – for example it is important in the context of recovery and resolution plans (see below).

The potential classes of individuals who may be within the FSA rules carry the same issues as for the remuneration reports mentioned above. Indeed they are even less certain – in particular there is not even the constraint of a "prescribed connection" for persons who are neither "officers" (we note that the definition in clause 10 does not apply) nor employees. Historically the FSA has been mindful of the allocation of responsibilities under EU law, but it is unclear whether it is required (or would rely on its wording) to ignore such allocation when making these rules – the territorial issues mentioned above apply equally here. The formulation of this rule-making obligation contrasts markedly with the proposals made last year by the EU Commission which related controls to individuals whose professional activities have a material impact on the risk profile of a firm. In the context of the proposed new EU-wide institutions it would be highly unsatisfactory for the FSA to face pressure from the EU that conflicts with a straightforward reading of the obligation proposed in clause 11. This draft Bill adds to that an obligation on the FSA to breach the EU limitation on the rules that it can impose on EEA firms and their employees.

It is unclear what purpose, other than allowing express interference by Government, is served by the proposed power for HM Treasury to direct the FSA "to consider whether the remuneration policies" of specified authorised persons comply with the rules. On its face HM Treasury is given the opportunity to override FSA's consideration of its section 2 obligation (on the most appropriate use of its resources) to force investigations of remuneration policies irrespective of the merits of doing so. The obligation on HM Treasury to consult before imposing a formal direction would in practice be likely to amount to an informal direction.

Section 3. Short selling - Clause 13

A. Overview

1. Clause 13 would insert a substantial new Part (8A) into the FSMA - nine new sections providing the FSA with new powers to prohibit or require disclosure of short selling, and ancillary powers for investigation and enforcement purposes.

2. We would reiterate two broad points which we made in our response to the FSA's discussion paper on Short Selling last spring[1]:
   a. To the extent that it may be necessary to intervene to maintain or restore stability and order in the markets in times of extreme market stress or fragility, we do not consider the market abuse provisions to be the appropriate framework for such measures and therefore it is vital to ensure that any long-term powers provided to the FSA to make any emergency interventions be placed on a proper statutory footing; and
   b. A consistent set of short selling measures across European and other significant global markets is a priority, and that achieving this should be a key objective of the FSA - we therefore welcomed the FSA's endorsement of the desirability of seeking as wide as possible an international consensus on the short selling regime and at a minimum, a more harmonised approach within the EEA. (which the FSA re-emphasised in its Feedback Statement[2]) and that,

[1] SP 09/1, February 20090, and our response at http://www.citysolicitors.org.uk/FileServer.aspx?oID=575&lID=0

[2] FS09/04, October 2009

in view of the work being carried out by both IOSCO and CESR, in which the FSA has been closely involved, the FSA to defer any final decisions on the issues under discussion pending the outcome of that work, in order to ensure a fully coordinated regulatory approach. As the EU Commission stated in its Call for Evidence in the Review of Directive 2003/6/EC on insider dealing and market manipulation (Market Abuse Directive)[3]: "We consider that divergent measures on short selling in the Member States might be difficult to reconcile with the objective of developing integrated and efficient financial markets in the EU. Market participants will need to bear undue costs of compliance with multiple EU regimes and cope ".

3. There are numerous flaws in the approach, scope, definitions and drafting, some of which are similar in nature to concerns we express about other new provisions. In particular:
    a. The degree of delegation seems excessive, largely unconstrained by purpose, definition or safeguards;
    b. The impression is created of wholesale delegation to the FSA, even power to define the scope of the powers in some respects[4], because Government will not take the time to ensure the primary legislation is right, and makes no provision for control through secondary legislation;
    c. There are serious rule of law issues;
    d. However, beyond issues of the rights and protections of those who might be restricted by rules made, or investigated or prosecuted in connection with possible breach, the provisions present a threat to:
        i. the very objectives espoused in respect of the emergency rules, namely confidence in and stability of the UK financial system, and
        ii. confidence in the UK as a properly governed and regulated environment in which to establish and/or conduct business.

4. This section elaborates these criticisms and suggests changes to address them.

B. Excessive delegation

1. The FSA would be almost wholly unconstrained as to the nature and purpose of the rules it may make under Part 8A. This contrasts starkly with Part 8 of the FSMA (Penalties for Market Abuse), which provides a detailed definition of market abuse, and defines clearly the scope of the code the FSA must issue, even though that code is only guidance – whereas Part 8A is a rule-making power.

2. The approach of specifying powers in inclusive rather than exhaustive terms, and the breadth of definitions, exacerbates this issue. In particular:
    a. the definition of "financial instrument" is excessively wide;
    b. the definition of "short selling" merely identifies a particular case, which is in any event misconceived;
    c. no purpose for the rules is stated, which could give the powers context.

    These points are elaborated in the following paragraphs.

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[3] 20 April 2009 at http://ec.europa.eu/internal_market/securities/abuse/index_en.htm

[4] In particular, clauses 131B(5) and 131C(4)(b)

3. *Scope of financial instruments covered by the regime:* Clause 131C defines "financial instruments" in absurdly broad terms:
    a. In the financial crisis, short selling as an issue has arisen only in relation to equities: although other instruments may be taken into account in determining whether there is a net short position, the focus should be on whether that net short position is in respect of shares. The debate on short selling over the last 18 months[5] has been almost entirely focussed on equities, and that is right.
    b. If there is a perceived need to have a reserve power to extend the scope of the powers to debt securities, then any such extension should be introduced by statutory instrument, subject to the positive resolution procedure.
    c. We think it is nonsensical to contemplate short-selling of financial instruments which are neither shares or bonds, except (as indicated above) to the extent that a position in a related derivative should be taken into account in determining whether there is a net short position and, if so, its size.
    d. To introduce powers that could enable the FSA to regulate short selling of financial instruments other than securities risks bringing the UK markets and regulation into disrepute and putting the FSA under pressure to regulate for reasons other than confidence in and stability of the financial system. If the FSA were delegated power to regulate short selling of gold, oil, interest rates, etc. outside of the scope of the existing market abuse regime in Part 8, FSMA, it may be called upon to justify why it is not exercising those powers, for example, to prohibit short positions in relation to environmental instruments in order to push carbon prices higher: the FSA should not be opened unnecessarily to these kinds of political pressures.
    e. There is no need to refer to MiFID for definition here: it would suffice to rely on clear definitions of investments in the RAO[6], and amend in due course if necessary to reflect any EU legislation in this area.
    f. In short, the draft definition of "financial instrument" is too broad and should refer only to Shares (as defined in Article 76 of the RAO) and RAO, Article 80 investments representing Shares.

4. *Defining "short selling":* Clause 131C(2) purports to assist in the definition of short selling, but does not clarify:
    a. It is confused, because being short is about a net position, and if short selling is to be defined at all it should be defined by reference to a person's net position (and what is taken into account in determining that), not in terms of the effect of a particular transaction on its own.
    b. The definition is inclusive rather than exhaustive: the legislation should either include a clear definition of short selling or leave the term undefined: simply identifying one or more cases, in effect for the avoidance of doubt in relation to those cases, actually creates more uncertainty as to the meaning of the term "short selling" as used in the legislation.
    c. For example, 131C(2) could restrict the reduction of a long position: it could apply to a situation where the holder of a long position buys a put option to hedge part of his position - even though overall, the holder may lose when the value of underlying decreases, the option itself arguably confers an advantage in the event of such a decrease.

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[5] For example, FSA's Discussion Paper DP09/01 of February 2009, responses thereto and feedback thereon.

[6] The FSMA 2000 (Regulated Activities) Order 2000

5. *Purpose of rules*:

   a. To provide some focus for the rules, and a benchmark by which they can be judged, the purpose(s) of the rule making power should be specified. This would be highly desirable in any event, since it is unsatisfactory for a delegated body to have rule-making powers without objectives and objective criteria for exercise. However, specifying these is essential given the extent of discretion proposed to be delegated.
   b. Specifying purposes for emergency action in the manner of clause 131D clouds the issue for rules made in other circumstances: the purposes expressed in 131D(1) represent what one might have supposed would be the purpose of any short selling rules, yet they are not criteria governing the exercise of the basic rule making powers in 131B(1). The latter cannot be regarded as qualified by the purposes specified for emergency rules, particularly given proposed new section 415A as set out in Schedule 2. They should be, and if there are other or different purposes for the exercise of 131B(1) those should be specified.
   c. A further reason to clarify purpose is the potential flexibility conferred in 131B(1) by the phrase "in specified cases": it is not at all clear how wide or narrow FSA's specification could be.
      i. For example, could the rules state that persons are prohibited from selling short shares in XYZ Bank PLC, or identify particular persons or classes of persons who may not short sell those shares (or shares generally)? Whilst it could be difficult to clarify the phrase "specified cases", it should be possible to provide statutory context through purposes, beyond the objectives and factors in FSMA, section 2.
      ii. This would preclude the powers being used as a consumer protection measure: for example, to prohibit short selling by managers of funds invested in packaged products.
   d. In addition, the legislation should specify particular factors to which the FSA must have regard in exercising its powers in this particular area – for example those in FSMA, section 2(3)(c), (e) and (f) and something equivalent to section 119(2A) to cater for potential European legislation or codes in this area.
   e. It is also very important that the FSA, when in making any rules under 131B (even, indeed especially, in the urgent circumstances of 131D), should assess and conclude that the rules will not damage the UK financial system or confidence in or the stability of that system. As we explain below in the context of emergency rules, the FSA's hastily introduced short selling rules (in the form of guidance) in September 2008 could have seriously damaged the UK's financial system, and safeguards are necessary to ensure no recurrence of that episode.
   f. Assuming that the purpose of any rules is financial stability and confidence in the financial system, the FSA should be required to obtain the agreement of the other Tripartite Authorities before it makes any rules.

6. *FSA's ability to determine its own powers* Beyond unnecessarily wide definitions that allow the FSA to act across a broad range of business where no risk has been identified, there are several provisions that empower the FSA to define the limits of its own powers under Part 8A. For example:
   a. Clause 131B(4) permits disclosure rules to have retrospective effect where "the resulting *position is still open*[7] when the rules are made" but:

[7] Our italics

i. Does not make clear that the rules may not otherwise have retrospective effect: it should do;
ii. FSA itself would be permitted under 131B(5) to determine the extent of its power because it is expressly empowered to define the phrase italicised above: if not in primary legislation itself, the meaning of a short position being open should be defined by Order.

b. Clause 131C(4)(b) allows the FSA to extend the meaning of "relevant financial instrument", in defining the powers delegated to the FSA in 131B(1) and (2), by specifying other connections a financial instrument may have with an EEA market. This should be a matter for secondary legislation, and the territorial scope issues described below should be addressed.

7. In short, the definitions in 131C could scarcely have been wider: their breadth is not at all justified by events in the financial crisis, and there are specific flaws that should be corrected.

C. Territorial scope

1. The geographical connection of financial instruments with the UK and other EEA States is also confused and the provisions inappropriate.
2. Whereas a "UK financial instrument" must be admitted to trading here, a broader range of connections (as yet unspecified) to markets in EEA States is envisaged in determining the overall scope of rule making powers by reference to "relevant financial instruments":
   a. Since the regime is intended to protect the UK financial system, its territorial scope should be limited to UK markets and UK issuers. This might help to address uncertainties which undermine compliance with the Human Rights Act 1998 and the European Convention on Human Rights, particularly Articles 6 and 7.
   b. We consider it inappropriate to be delegating powers to prohibit actions overseas in respect of instruments issued by persons overseas which are legal under applicable laws in the relevant overseas jurisdictions, particularly without reference to there being any substantial effect in the UK.
3. In any event there are specific inconsistencies and other issues in the way the territorial scope is delimited:
   a. It seems inconsistent that short selling rules could apply to shares of a listed Swiss issuer by virtue of its holding a majority interest in a listed French issuer (if the FSA specified such types of connection for the purposes of 131C(4)(b)), but that under 131B(6) such rules would not apply to short selling of that share wholly outside the UK by persons outside the UK even if the Swiss company had a similar connection with a listed UK issuer.
   b. There appears to be conflict between 131B(6) and the provisions of 131C(7) and (8).
   c. It is not clear what "short selling wholly outside the United Kingdom" means: the foreign holder of shares in a London-listed foreign bank presumably benefits from 131B(6) if he is net short due to derivatives entered into outsides the UK even if he bought some of his shares in on the London market, and even if he sells shares short on a foreign market but borrows stock from a UK institution.
   d. Nor is it clear what is meant by "a person outside the UK" in 131B(6): presumably it includes a UK bank selling short where the trader concerned is in a foreign branch.
4. Again, it is inappropriate for the FSA to be delegated the power to determine the scope of the regime, by specifying connections with EEA States as part of the definition of "relevant financial instruments"

to which the short selling rules can apply. It is difficult to believe that the criterion of connection with a market in an EEA State will be a defining characteristic in terms of what may or not bring down the financial system, unless the concept of connection is interpreted dangerously widely. The FSA should not be able to prohibit short selling in the UK of overseas financial institutions' shares if those shares can be sold short in their domestic or main market.

D. Urgent Cases

1. Caution and safeguards (including consultation) are essential to ensure that legitimate business is not undermined – that is the lesson of recent history of emergency rule-making in the area of short selling. Poorly drafted rules may have unintended and unfortunate consequences:
    a. When in September 2008, with minimal and no formal prior consultation, the FSA issued guidance by way of immediate amendment of the Code of Market Conduct, that guidance contained significant flaws in implementing the policy of prohibiting short selling of financial sector shares.
    b. Substantial changes were necessary, made over subsequent days and weeks, to address problems arising from the guidance - such as insufficient flexibility for market makers to hedge, the creation by the guidance of irresolvable conflicts of interest for fund managers, and inadequate distinction of disclosure provisions from prohibitions (for example, in rules on aggregation).
    c. Without such changes investment banks and investment managers would have been impaired in their equity market making and discretionary management functions, which could have damaged the UK financial system and stability and the reputation of the City and of UK regulation.

2. Two factors, especially, emphasise the need for safeguards in clause 131D:
    a. An important factor in avoiding seriously adverse consequences in late 2008 was the fact that the FSA's provisions were only guidance, so regulated firms and others could adopt a sensible view on whether their conduct could in fact amount to market abuse within the meaning of section 118(8)(a) of the FSMA, and FAQs and informal conversations with FSA staff helped to mitigate the consequences of the flawed Code changes. Persons acting to comply with rules under Part 8A would have no choice about compliance, no flexibility to take a sensible view, and informal guidance from the FSA cannot detract from clear but misconceived rules.
    b. Whilst the FSA and other regulators have learned lessons from the experience of legislating against short selling in September 2008, the breadth of powers proposed in Part 8A would put the FSA in uncharted territory, able to make rules without prior consultation.

3. Recommended safeguards:
    a. The FSA should be required to perform such consultation as is reasonably practicable before making emergency rules, even if it cannot follow the section 155: even convening at short notice a meeting of City practitioners and trade association representatives would be better than no consultation – the rules might still be flawed but this would be less likely and the flaws probably less serious.
    b. As stated above, the FSA should be required:

i. To assess its proposed rules and conclude that they will *not* damage the UK financial system or confidence in or the stability of that system; and
ii. To obtain the agreement of the Tripartite Authorities to the making of emergency rules – it is quite inappropriate that they are not a formal part of the process given the stated objectives of emergency rules.

These points are all the more important where there has been no consultation.

c. The FSA should be required to monitor continually the effects of emergency rules and review them within one month, as it did in September/October 2008, taking into account representation received.
d. Regarding extension of the period of the emergency rules under 131D(3) the FSA should be:
    i. required to announce at least 15 days in advance of its intention to including an explanation of its reasons for doing so, then consult on the matter so far as reasonably practicable, and
    ii. empowered to extend the emergency rules without such advance announcement only if the FSA changes its intention as a result of significant events occurring after its decision not to extend.
e. Purpose/objectives: Clause 131D(1) is ambiguous in defining the factors which justify emergency rules. Presumably it is not simply the need for rules to maintain confidence in, and protect the stability of, the UK financial system that drives reliance on 131D, since those should be the purpose of any rules made under Part 8A. Rather the decisive factor for the FSA here is urgency. The drafting should make that clear.

E. Ancillary powers

1. The ancillary investigation and enforcement powers proposed in Part 8A to support the short selling regime broadly reflect powers that are similar to:
    a. powers proposed elsewhere in the Bill, and on which we comment elsewhere in this submission; and/or
    b. powers already in the FSMA, particularly in relation to market abuse.

2. Accordingly, we do not comment on them here except to the extent that we have identified issues arising from them which are not issues of more general concern, in relation to those other, similar powers.

3. Defences and mitigation
    a. We consider that some of the defences and mitigating circumstances in Part 8 of the FSMA in respect of alleged market abuse should be reflected in Part 8A. In particular:
        i. There should be an equivalent defence to that in Section 123(2);[8]
        ii. Clause 131I(2) should be extended to require the FSA's policy on penalties to have regard to the matters in section 124(2)(a) and (c)[9] for market abuse; and

[8] FSMA, section 123(2) provides: ""

[9] FSMA, section 123(2)(a) and (c) provide: ""

iii. The statement of that policy should be required to include indications equivalent to those in section 124(3)[10] concerning reasonable belief, reasonable precautions and due diligence.

b. These protections are all the more important given the FSA's power to introduce new rules without warning, just as it can amend (and did amend) the Code of Market Conduct.

4. *Limitation period* We consider that four years is an excessive period for matters that should be relatively easily investigated and assessed, and we suggest that a period of two years would be more appropriate under clause 131F(5).

5. *Effect on transactions* Short selling in contravention of the prohibition should not affect the validity or enforceability of transactions. Since that is made clear in respect of market abuse (FSMA, section 131), we consider that a similar provision should appear in Part 8A.

6. *Information gathering* The financial stability backdrop to Part 8A, and especially the specific objectives provided for emergency rules, have implications for the proposed new powers for the FSA to gather information concerning financial stability.[11] In addition to these powers being subject to section 413 of the FSMA, we consider that it should be made clear that they cannot be exercised in investigation of breaches of short selling rules. Otherwise we believe that Convention rights under the HRA may be infringed.[12]

Section 4. Recovery and resolution plans

As with the provisions of the Bill relating to remuneration, the proposal to impose specific rule-making obligations on the FSA raises a number of legal issues.

The interaction of this obligation with the FSA's existing FSMA obligations on rule-making (including obligations on consultation, cost benefit analysis) is unclear.

On the face of proposed section 139B(1) the FSA will be required to make recovery plan rules for every authorised person. It is not clear that the bracketed wording actually has the effect contemplated in the Explanatory Notes (i.e. the FSA can choose whether it is for all or for a particular class of authorised person). Nor is it clear that the FSA can make different provisions (including none) for different classes of authorised person (e.g. IFAs compared with banks), as one would expect in the light of the FSA's obligations under FSMA section 2, for example to have regard to competition and proportionality, and its obligations to take account of consultation responses and its cost benefit analyses.

The proposed sections repeatedly define the scope of the FSA's obligation and powers to make rules by reference to provisions "specified" in the rules themselves (e.g. proposed section 139B(1), (2), (3), section 139C(1), (2) and section 139E(1)). This means that, in effect, the FSA can define the scope of its own obligations and powers. For example, the FSA is required to adopt rules requiring authorised persons to prepare and maintain a "recovery plan" but the relevant trigger event in which the recovery plan is to be activated is to be defined by the rules themselves

[10] FSMA, section 124(3) provides: ""

[11] Proposed section 165A, as set out in clause 30 of the Bill.

[12] See our other comments on these powers, below.

(indeed, on one alternative – that described in proposed section 139B(4) – the recovery plan does not even require an trigger event: the recovery plan is just a document containing information relating to facilitation of the carrying on of the business of the authorised person in normal circumstances). Similarly, the proposed legislation does not define the trigger point at which resolution plans are to be activated, as it only offers a partial (non-exhaustive) definition of what constitutes "failure" (proposed section 139C(3) and 139D(3) and (6), which also do not exhaustively define the insolvency, bankruptcy or administration events to which they refer), again leaving it to the FSA to define the scope of its own obligations and powers.

Proposed sections 139B(7) and 139C(8) state that the steps that the FSA may take, when dissatisfied with a firm's plan, include "requiring the ... plan to be revised". However, it is unclear whether this is an independent power to impose requirements on an individual firm. If it is, it should be accompanied by appropriate procedural safeguards and rights to refer the matter to the tribunal, in the same way as where the FSA seeks to impose requirements on a firm using its own-initiative powers under Part IV FSMA.

The obligation placed on the FSA to consider each plan (proposed sections 139B(5) and 139C(6)) means that the FSA cannot decide to review the plans of some authorised persons on a spot check/inspection basis. Therefore, the FSA will only be able to make rules requiring plans to be made by firms where the FSA is confident that it will have the resources properly to review the plans, presumably in each case promptly after they are changed in any way. This undermines the FSA's ability to take a proportionate, risk based approach to review.

The extension of the scope of proposed sections 139B and 139C to include related entities appears to impose duties on the FSA to ensure that its rules cover the business of a firm's related entities regardless of their materiality to the authorised person or to the objectives that the rules are intended to serve.

Proposed section 139D(2) limits the definition of a "group" for the purposes of proposed section 139D(1)(b). However, it should also similarly limit the reference to other members of the "group" in proposed section 139D(4)(a).

It is wholly inappropriate to allow a skilled person to impose a statutory duty on anyone it chooses to provide assistance to it in the performance of its functions (proposed section 139E(4)). For example, this would allow a skilled person to secure the services of third party contractors or professional firms (who might have no connection whatsoever with the authorised firm) free of charge to assist it in the performance of the functions for which it is paid. This goes considerably further than the corresponding provisions of section 166(5), which are themselves more restricted in practice because of the more limited role that a skilled person has under section 166. In this case, the obligation to provide assistance should be restricted to the authorised firm and members of its "group" (subject to the limitations on the definition in section 139D(2)).

Similarly, it is wholly inappropriate to give the skilled person (even with the sanction of the FSA) powers to override any confidentiality obligations owed by third parties simply to obtain information that it considers relevant for its purpose. For example, the powers are broad enough to allow the skilled person to require the disclosure to it (without compensation) of it of confidential, proprietary technology or know how belonging to a third party (which might have no connection with the authorised person) simply because it might be helpful to the preparation of a plan. There is no need for this power. It should be sufficient to impose a duty on the authorised firm and its group companies to provide assistance to the skilled person, who cannot be in a better position than the authorised firm itself in this regard.

Since the appointment of a skilled person is a consequence of an alleged breach of rules by the authorised firm, the firm should have the benefit of appropriate procedural safeguards and a right to refer the matter to the tribunal.

Section 5. Proposed FSA information gathering powers

Again, the proposal appears to be inappropriately broad.

The primary function of the new powers is to give the FSA power to require information from the legal and beneficial owner of assets in a relevant "investment fund" (and the managers of such a fund). However, the statute does not define an "investment fund", except to expand it in such a way as to cover the investment portfolio of any investor (proposed section 165A(9)).

In addition, the information that the FSA can require from such a person (or its group companies and other "connected persons") is not limited to information which relates to the investment fund in question. The FSA can require the provision of information on any subject it thinks might be relevant to its financial stability objective.

It is inappropriate to give the FSA effectively unfettered powers to require any information it likes from any investor anywhere in the world (and its connected persons), merely because the investor's portfolio includes financial instruments that have some connection with the UK and because the FSA considers that the information might be relevant to its financial stability objectives. At the very least, these powers should be limited to cases where the investor's activities pose or would be likely to pose a serious threat to the UK financial stability and where the information required relates to the investment activity in question. After all, this is the basis on which the Treasury has powers to expand the scope of application of the new powers under proposed section 165C.

With respect to the powers to require information from "service providers" to authorised persons (and their connected persons), it is helpful that the FSA can only require information if the way in which the service is provided or a failure to provide the service in question is likely to pose a "serious threat" to financial stability. However, the FSA can ask such a service provider (or its connected persons) for information about any subject, whether or not related to the services in question. In addition, service providers have no automatic recourse to their client in respect of any additional costs resulting from their compliance with such a request or requirement.

The definition of "connected persons" is inappropriately broad in so far as it includes 10% shareholders (controllers) or minority "participating interests" (new section 165A(10)).

We would be delighted to discuss the above observations and suggestions with you. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully,

pp J-Yang

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