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Dear Sirs

CM 7874: A New Approach to Financial Regulation

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.

The Committee would like to comment on certain issues and questions raised in the Government's consultation on reforming the UK's financial regulatory architecture.

We start (somewhat reluctantly, as will be apparent from our more detailed comments following) from the premise that the high level structural reforms which have been proposed by the Government, namely the creation of the FPC and the transfer of the FSA's existing regulatory functions and responsibilities to, principally, two new regulatory authorities, is a fait accompli in the sense that it reflects a political policy decision taken in the run-up to the recent election and re-affirmed shortly thereafter. This premise is reflected by the nature of the questions posed in Annex A to the consultation document.

We shall not therefore comment further on that 'macro' aspect of the proposals.

The comments which follow do not in all cases address specific questions set out in the consultation, but where relevant we have noted the questions to which our comments are most pertinent.

1. The division of responsibilities and coordination of processes (Questions 5)

Our main concern (a concern which also informs many of the more specific points made below) is that the consultation document underestimates the difficulties of unpicking and dividing up the present legislation (principally FSMA itself, but also including the Regulated Activities Order and the FSA's rules made under FSMA) and distributing responsibilities for the various elements between the PRA and the CPMA; and overestimates the virtues of what is referred to as the "collegiate" solution to the supervision of institutions subject to the jurisdiction of both authorities.

We observe that:

- notwithstanding the assertions in the consultation document that "*prudential and conduct of business regulation require different approaches and cultures*" not suited to be housed in a single regulator, recent experience has lead both the regulator and the regulated to acknowledge that "*prudential*" and "*conduct*" labels do not often denote distinct regulatory jurisdictions, but rather different aspects of the same territory (for example, the quality of a firm's management or its systems and controls). Any partition of FSMA, the RAO and the FSA's Handbook will need to take this into account and will, accordingly, be extremely complex – with inevitable implementation difficulties for regulators and firms.
- given the above-quoted major premise as to the necessity to separate conduct from prudential regulation, it is a surprising proposal that the CPMA will become a prudential and conduct regulator of the majority of firms. It will seemingly be both in fact (and, we understand, law) a continuation of the FSA but with a truncated constituency.
- the necessity of establishing collegiate arrangements for major institutions effectively re-establishes a 'shadow' single regulator for such institutions – but without the benefit of a properly unified regulatory organisation and with all the complexities and burdens, for the regulated constituency, of dealing with two formally separate regulators (as to which see the more particular comments below).

2. Statutory objectives (Questions 4 and 10)

We think the case for the removal (for both the PRA and CPMA) of the innovation and competitiveness objectives presently provided for in FSMA may be overstated. There are distinctions to be drawn between:

- the desire for the UK to be "*excessively*" competitive (in practice meaning a place of light touch regulation) and the desire for the UK to be competitive in the sense of having clean, efficient and well-regulated markets, attractive to high quality firms.
- innovation consisting in the manufacture and distribution of new, well-researched and prudently marketed products and services responding to customers' needs and the blinkered, commission-driven manufacture and misselling of poorly-understood products to customers for whom the products are unsuitable.

In both cases the former types of competitiveness and innovation are worthwhile objectives and should be retained, even if there is a desire perhaps to recast them in a more focused form.

3. Rule-making powers and accountability (Questions 4, 6, 7 and 9)

It is stated (at paragraph 3.20 of the consultation) that the PRA is to have:

"*the core regulatory function of making the rules which govern the performance of regulated activities by financial firms [i.e. those subject to prudential supervision by the PRA]*",

and it is stated (at paragraph 4.8) that the CPMA is to have:

"the core regulatory function of making the rules which govern the conduct of [all] financial firms, in both retail and wholesale sphere"

Taking up the major theme of this submission - it is at present unclear what distinction is intended between the concept of "*performance*" (of regulated activities) and "*conduct*" and this raises the further question of where the respective future draftsmen of the new rulebooks will start, if indeed they start separately?

- Again the ambiguity of the proposal indicates the implicit concession (which, for the reasons stated above, we consider must be made) that "*conduct*" and "*performance*" (if the latter means prudential aspects of carrying on business) cannot readily be separated in many key areas.
- We suggest that it will therefore be necessary, and beneficial, to encourage or require a collegiate approach to much of the rule-book(s). Again, a shadow single regulator thus would begin to emerge.

It is not clear from the consultation document (in particular see paragraph 3.22 and Question 7) whether the Government is inclined towards making the PRA less accountable for its rule-making than the FSA is at present. Certainly, the discussion is at best neutral, whereas it is apparently settled that the CPMA will continue to be accountable in the same manner.

- We strongly urge that (except in carefully circumscribed circumstances, such as a rapidly developing crisis), the PRA is subject to consultative and cost-benefit analysis disciplines. We do not consider it to be a reflection on the wisdom and abilities of any regulator (or indeed legislator) to say that most proposals are improved by the consultation process.
- Consultation is an essential process for ensuring that regulation develops in a coherent and practicable manner, and avoids unintended consequences (including adverse effects on competition and innovation).

4. Authorisation, approval and passporting processes (Question 5)

The authorisation, approval and passporting processes have in particular potential to cause firms confusion and unnecessary burdens of duplicate regulation.

- If both the PRA and the CPMA are to be responsible for granting permissions (and therefore authorised status) in their respective jurisdictions, multi-service PRA firms will have to undertake two sets of applications and manage two parallel processes, both for the firms themselves and for individuals (some of whom will need to be approved for different roles by different regulators). This, for the firms affected, will be a substantially detrimental step back to the pre-FSMA fragmented supervisory regime. Such inefficiencies, in fact, were among the key drivers for abandoning that system of supervision in favour of a single unified regulatory authority.
- If on the other hand one regulator (presumably the PRA) was made responsible for all authorisation and approval decisions (as queried in Question 5), it would also presumably follow that it should then become the prudential regulator for all firms on the basis that it could not be consistent with principles of good regulation for the PRA to make such decisions in respect of a firm or individual for which it would not then be required to assume a prudential supervisory role. This would leave the CPMA very much as the junior partner of the two authorities, and substantially weaken its position as a conduct regulator. Withdrawal of authorisation (or approval, in the case of individuals) is a potent weapon for a conduct regulator.
- For this reason, there is also now a real risk that the CPMA's effectiveness as a standalone conduct regulator of the largest financial institutions (most of which will be PRA-supervised firms) will be compromised from the outset: in practice the limited ability to impose fines on institutions

which are typically not much inconvenienced by such financial measures (at least without enforcement cooperation from the PRA) will not be regarded as an adequately potent weapon with which to control errant conduct behaviour.

- A collegiate approach – a joint application and approval committee of the PRA and CPMA – may be the most efficient means of dealing with applications from firms subject to both PRA and CPMA supervision. We would then question whether a logical extension of that principle would be to create a standing joint committee to consider all applications across the jurisdiction of both the PRA and CPMA. This could have the benefit of ensuring that standards are applied consistently between the two authorities. It may also facilitate a form of domestic 'passporting' of approvals between the two authorities for cases where, e.g., an advisor/arranger firm which is subject only to CPMA supervision seeks to become a broker-dealer firm with permission to deal as principal.

5. Enforcement, including market abuse

The proposed division of responsibilities will lead to two enforcement regimes for breaches of requirements imposed by the PRA and the CPMA, a market abuse regime administered by the CPMA and, potentially, a separate criminal enforcement regime administered by a new Economic Crime Agency. We are concerned that any such fragmentation of enforcement domains could substantially weaken the credible deterrence initiative championed by the FSA and that the UK's reputation as a robust financial centre in which to do business could suffer as a consequence.

- The consultation document does not address in any detail the matter of overlap: "*It may also be necessary in some circumstances, for enforcement action to be co-ordinated...*" We suggest that these circumstances will in practice be "many", and the most obvious example is perhaps where conduct problems arise from systems and controls failings or the weakness of management.

- It is unclear what "co-ordinated" enforcement action is intended to mean in such a case:

    - Two sets of processes, legally separate (perhaps reaching different findings or part and integration)?

    - Or a unified procedure?

- If a unified procedure is an option, many further questions are raised: could either authority decide to engage the procedure, and which authority would lead? what would happen if in the course of a unified investigation it became apparent that the subject matter raises issues falling within the formal jurisdiction of only one of the authorities? and, most importantly, what would be the legal basis for such a procedure?

- None of these models are attractive from a legal perspective, and they each give rise to potential complexity and uncertainty for regulated firms. Equally, the burden for firms of potentially having to deal with dual enforcement processes could be significant, and the scope for confusion and overlap between investigating authorities must be substantial.

- Moreover there is the potential for conflict in the case of systemically important firms between the objective of the CPMA to punish and deter errant market conduct, perhaps through withdrawal or suspension of permissions or approval, and the objective of the PRA to minimise systemic risk, which may include avoiding such significant supervisory interventions.

- The consultation document explains that a consultation on the powers of the ECA will follow, but we note for the time being that the inefficiencies of any fragmentation of civil and criminal market abuse and insider dealing investigatory and disciplinary powers between the CPMA and the ECA can be expected only to extend and aggravate the difficulties mentioned above. We would prefer to see a single enforcement authority retain both civil and criminal enforcement powers in relation

to market misconduct, including in relation to market abuse, insider dealing and market manipulation.

6. Regulation of markets (Question 17 and 18)

We note that the Government is considering whether to merge the UKLA function of the FSA with the Financial Reporting Council ("**FRC**") to consolidated companies and reporting regulation into one place. We suggest that responsibility for the regulation of markets should be concentrated within the CPMA.

- While we acknowledge the apparent logic of the proposal to establish a powerful companies regulator, we are concerned that any perceived benefit of such a consolidation will be offset by the potentially negative outcome of separating responsibility for and oversight of primary market activity (which should fall squarely within the domain of the CPMA) from that for secondary market activity. The consultation document itself acknowledges the "*synergies that exist between the UKLA and other market functions*".
- A good reason for keeping the UKLA function within the CPMA is to recognise that the boundary between primary and secondary market activity at the time of issuance is not in all cases a clearly defined boundary, and the ability of the market regulator to provide a joined-up approach to the supervision and policing of primary and secondary markets is therefore of significant practical benefit.
- Moreover, if the UKLA function were to be transferred to the FRC, it would presumably follow that the FRC would need to acquire new enforcement competencies in relation to the primary markets. A further fragmentation of enforcement powers, and resources, cannot in our view be desirable, and risks further threatening the viability of the credible deterrence initiative, and thus damaging the UK's reputation as a leading primary market.
- There has been no suggestion that the UKLA's stewardship of the listing authority's function has been flawed and we therefore urge the Government to reconsider whether a transfer of such functions is necessary, or would be substantially productive, at this stage; our preference would be to avoid any unnecessary structural reorganisation and to ensure that the CPMA can function as a fully-competent regulator of markets.

7. Crisis management (Questions 19 to 21)

It is proposed that the Bank of England (the "**Bank**"), both directly and through the agency of the PRA, will be given enhanced powers to deal with financial crises, including overall responsibility for co-ordinating resolution action when it next becomes necessary.

- It is intended that the FPC will use its macro-prudential toolkit to respond to systemic threats to financial stability, with the objective of avoiding the need for crisis management at the level of individual firms. If these measures are not successful, however, the Special Resolution Regime ("**SRR**") may need to be invoked.
- In addition to its responsibilities for supervising individual firms, the PRA will also be responsible for requiring "management action" from individual firms that run into difficulties (which may, for example, include requiring the firm concerned to issue new equity capital) and ultimately for triggering the SRR for failing institutions.
- The existing Special Resolution Unit within the Bank will have responsibility for contingency planning prior to the SRR being triggered and for coordinating measures subsequently deployed under the SRR.
- While we accept the logic of locating these important crisis management functions in one place we are concerned that the Bank (in its many guises) will assume multiple roles the objectives of which

will not be entirely aligned, and may in fact begin to diverge in the very circumstances in which a coordinated approach has been demonstrated to be critical.

- By way of example, we query whether the PRA may be reluctant to trigger the SRR, and thus implicitly acknowledge a failure of its own micro-prudential supervision of the firm concerned. If the Bank, as lender of last resort, finds itself in the position of prolonging the life of an ailing institution, will it be open to the challenge that it had acted to protect the interests of its subsidiary, the PRA?
- As the consultation document acknowledges, *"[i]t is important to ensure that appropriate safeguards are in place to ensure that conflicts do not arise between the Bank's role as lead resolution authority and the Bank's new responsibilities in relation to the PRA".*
- A solution proposed in the consultation document is to ensure that contingency planning and resolution operations are managed distinctly from the PRA's prudential supervisory operations and will fall within the remit of the Deputy Governor for Financial Stability and not the Deputy Governor for Prudential Regulation. We are concerned that such measures may not prove effective in extreme conditions and this then begins to undermine the rationale for co-locating the related crisis management functions in one place.

We are also concerned by the suggestion that the existing power of the FSA to modify at its own initiative an individual firm's permission to carry on regulated activities could be expanded, and that the trigger points for the PRA and the SRR might be modified *"to ensure intervention is possible before a breach of threshold conditions"*.

- Any movement towards giving greater discretion to the PRA to initiate interventions in the financial sector could potentially have significant consequences for the ability of UK institutions to raise new capital at a time when regulatory authorities are seeking to encourage, and in some cases to require, banks and insurers to do just that.
- It will therefore be critically important to ensure that there is clarity as to the circumstances in which such interventions may take place.

One further change contemplated in the consultation document is to give the new authorities supervisory powers over certain unregulated companies, such as holding companies, in circumstances where a regulated firm is failing.

- If implemented, this would mark a significant extension to the scope of the UK regulatory jurisdiction. The FSA (and its predecessor bodies) has not sought to supervise unregulated companies directly; any attempt to do so could raise difficult questions as to the nature and extent of those new powers, particularly in cases where unregulated holding companies are incorporated outside of the UK.

8. International influence

There are, currently and imminently, a very great number of policy initiatives being undertaken at the EU level. These include far-reaching proposals such as the overhaul of the EU regulatory architecture, new capital adequacy rules and radical reviews of key single market directives (for example, MiFID). All of these proposals can be expected to have a potentially significant impact on UK markets and financial institutions, not to mention the powers of UK regulators. Some proposed measures, such as the AIFM Directive, may have a disproportionate and potentially deleterious effect in the UK.

- We share the concern of many commentators that to undertake radical reform of UK regulation at such a critical time of itself gives rise to a real danger that the UK's voice at the EU table will be subdued and weakened, whatever the final shape of the new, post-FSA, regime.

- We share the further concern that the PRA/CPMA model may be an intrinsically weak vehicle for representing the UK at the new EU institutions, especially the EBA and ESMA, because the division of prudential/conduct responsibilities under the UK proposals will not match the division of responsibilities between those two authorities. The PRA and the CPMA is inevitably therefore at risk of being perceived by European counterparts as lacking authority to contribute to certain aspects of the decision making of, respectively, the EBA and ESMA.
- In our view, the obvious collegiate solution – involving representatives from each of the PRA and CPMA (and perhaps also, for the macro perspective, the Bank of England) – if such multiple representation were possible, will be inferior to having UK regulators with authority and responsibilities which are equivalent to those of the most influential regulators from other Member States.

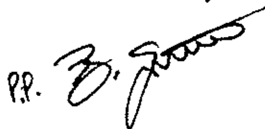
9. Implementation

Again, we share the concern raised by other commentators that the pre-legislative restructuring process which the FSA and the Bank of England have now embarked upon risks creating further substantial disruption both for the regulator itself and for the firms which it supervises and interacts with on a daily basis. As we note in the previous section, this comes at a time when the FSA's limited resources should be focused on supporting the stabilisation, recovery and growth of the UK financial sector and in representing the UK in European and international regulatory forums.

- While we support the principle that the FSA and the Bank of England should prepare themselves for the forthcoming legislative division of responsibilities (and resulting division of personnel and infrastructure), we are concerned that the FSA must not allow service standards to start to fall as senior resources inevitably need to be focussed internally rather than externally.
- We accept the practicality of the interim 'shadow' arrangements which have been proposed (and, we understand, are now starting to be implemented) to prepare the FSA for its eventually statutory division, but if that process is to avoid disruption to the UK financial markets it is critical that those reorganisation arrangements, and their progress, are transparent. Regular updates from the FSA and the Bank, at a minimum, would seem appropriate.
- At the same time we are concerned that the FSA (in its interim form), and in due course the PRA and the CPMA, must recognise that there will be a significant challenge for regulated firms in understanding and adjusting to the new dual-authority regime and the new supervisory cultures of the successor authorities; these challenges are likely to be particularly acute for those firms which will be supervised by both the PRA and the CPMA. Appropriate allowances will need to be made if the UK financial sector is not to bear unduly the costs and administrative burden of the Government's policy decision.

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



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