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David McIntosh QC (Hon)
Chairman

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By Email: financial.reform@hmtreasury.gsi.gov.uk

Dear Sirs

Re: CLLS Regulatory Law Committee response to Her Majesty's Treasury Consultation: A new approach to financial regulation - building a stronger system (CM8012)

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world.

This response to Her Majesty's Treasury Consultation: A new approach to financial regulation - building a stronger system (CM8012) (the "**Consultation**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across and outside Europe who operate in or use the services provided by the financial markets, These include clients on all sides of the market as well as market infrastructure providers. We are frequently involved in advising overseas firms who are seeking to establish a European presence and who are considering the U.K. as a possible lead jurisdiction, as well as advising a wide range of firms and individuals on enforcement matters. Our comments below on the authorisation and enforcement processes are therefore based on considerable practical experience.

1. GENERAL

We are not commenting on every question raised in the Consultation and have set out our comments below with reference to the question numbers concerned. We highlight in this section two areas of general concern, the first relates to the day to day operation of the new authorities, the second to the proposed change in approach on certain matters involving regulatory decisions

As explained in our previous comments we have not questioned the policy of creating a new regulatory infrastructure as this is clearly settled, but a structure involving more than one regulator carries clear risks of lack of effective coordination and related cost and uncertainty for firms. The implementing legislation must set a clear framework within which the authorities must operate and co-operate, to provide the markets and firms with the efficient and cost effective regulation that they need. If the U.K. is to remain a leading jurisdiction for the location of financial services firms then it must provide them with clear, effective and efficient processes for authorisations, variations of permission, approved person approvals and change of control consents, as well as fair processes in enforcement cases. Firms that have a choice as to whether to locate here (with the resulting jobs, tax revenue etc.) take into account the local processes when determining whether to base their head office in the U.K. or set up elsewhere in Europe and simply passport into the U.K. We know this from our own practices. The impact of the new structure on firms must be capable of being clearly described, so that firms know what to expect, who to deal with, and what time frames will apply. The proposals in the Consultation do not go far enough to ensure that this will be the result. We suggest below that there should be express duties to cooperate, a shared services function and identical rules where both regulators are implementing the same European laws, or making rules which cover the same territory. As far as European laws are concerned it is essential to avoid a position where different regulators appear to interpret the same rules in a different way, as in other Member States there will be one authoritative source.

We have already expressed to you our serious concerns about the proposals in relation to various changes in the provisions relating to enforcement and similar matters, such as refusals to approve individuals. We are strongly opposed to the proposals in their current form, as explained in our comments on the specific questions below. We highlight in this general section the concerns we have on the proposal to publish warning notices. We consider that it is unjustified, unfair and unnecessary. If the Government proceeds with it then it

will need to make significant changes to the entire framework within which they are produced. At present warning notices are highly selective as to their content, omit relevant material which does not assist the "prosecution" case and they are issued before the firm or individual has had access to the material which the FSA has in its possession or an opportunity to challenge what the notice says.

The suggestion that warning notices should be made publicly available is not justified. If the regulator has a case then it will appear in due course. In our experience, even when a warning notice is followed by a Decision Notice, the content is often materially different. As a recent public example has shown, premature publication of information about an investigation can have a devastating irreversible impact that is particularly unfair if the investigation concludes with no action. The same could happen with publication of warning notices-not every warning notice results in a Decision Notice. We urge HM Treasury to revisit these proposals, which also have a potentially damaging effect on confidence in the U.K. and on the reputation of the U.K. as a place to carry on business. We are of course supportive of an effective and appropriate enforcement process, it is essential that firms and individuals who break the rules are subject to proper sanction and, where appropriate, publicity, but the current proposal is not required to meet that objective.

2. BANK OF ENGLAND AND FINANCIAL POLICY COMMITTEE

In our response dated 15 October 2010 to consultation paper number CM7874 "A new Approach to Financial Regulation: Judgement, Focus and Stability" we deliberately made no comment on the creation of the FPC as a matter of principle. We express no view on that in this response either but we have a number of concerns in relation to the proposed role for the FPC, its accountability and the proposed power of direction in particular. These largely fall under question 3 and we are accordingly setting out our response in relation to that question first.

Question 3 - Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?

2.1 The FPC's proposed objective

We note that the Bank of England is to be given a revised financial stability objective, which will be to "protect and enhance" the stability of the financial system of the United Kingdom. The FPC's objective will be designed to link into the Bank's objective by requiring it primarily to identify, monitor and take action

to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. These objectives appear to envisage a continuous requirement to improve the level of financial stability in the UK, with no "steady state" ever being reached. The consultation paper says in paragraph 2.19 that the Government proposes to build a balance between financial stability and sustainable economic growth into the FPC's main objective as set out in Box 2B. The proposed wording in paragraph 4 of the FPC's objective is somewhat timid in this regard. The FPC is not required or authorised to exercise its functions in a way that would "in its opinion" be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the UK economy in the medium or long term. This is highly subjective and would give the FPC wide latitude.

This is underlined by the proposal in paragraph 2.23 that the Government will legislate to give the Treasury a discretionary power to provide the FPC with guidance in the form of a remit. We consider that the balance to be struck between financial stability and sustainable economic growth is quintessentially a political judgment for a democratically elected Government, and not one for the Bank of England or the FPC. The balance requires respective weights to be accorded to the risks to businesses, households and individuals of financial instability and the economic benefits generated for the UK as a whole by its financial services sector. That balance may change over time. We consider that the legislation should oblige the Treasury to set the FPC's remit, and that the tension between stability and growth be acknowledged in the FPC's remit more clearly. The FPC should be required to respond to the remit, setting out how it proposes to implement it. Simply requiring the FPC to take the Government's views into account would be insufficient.

This issue is relevant to the factors to which it is proposed to require the FPC to have regard. The consultation paper says in paragraph 2.20 that proportionality captures the need of the FPC to consider the likely benefits of its actions compared to the costs they would impose. While this may capture whether an individual intervention is, of itself, proportionate, it begs the question of the aim being pursued by the intervention. It is generally a requirement of proportionality that the measure pursues a legitimate aim. We do not consider that the proposals in relation to the FPC's remit go far enough in providing for the Treasury to identify the aims to be pursued by the FPC.

The legislation will clearly contain a large number of provisions relating to coordination between the FPC, the Treasury, the PRA and the FCA. Objective 2 says that that the Bank shall "aim to work with" other relevant bodies. While

we note that these words appear in the Bank's current financial stability objective, in the light of the Government's view of the failure of the Tripartite system introduced by the previous Government we do not consider that this is sufficiently ambitious or robust in relation to the operation of the new regulatory architecture. The relevant bodies should be required to work and cooperate with each other.

2.2 Exercise of functions

Paragraph 2.26 provides that the proposed levers at the disposal of the FPC need not be used in any particular order. We query whether this is the right approach (especially if the Government takes the view that the actions of the FPC are not justiciable for the purposes of judicial review – see below). In the recent financial crisis, risks in the system did not arise overnight. Early, graduated intervention may have been effective in significantly influencing market behaviour. And given the potentially invasive use by the FPC of its tools, we do not consider that it would be appropriate to provide the FPC with complete discretion. While we accept that it will be overly mechanistic to require the FPC always to exercise its powers in a set order to address a particular issue, we consider that the FPC should also be obliged to act here in accordance with the principle of proportionality. That is to say that it should be required to consider, before using its power to direct, whether its objective could not be attained by using a less invasive power/use the least invasive power to achieve the particular aim.

2.3 Accountability

Paragraph 2.28 of the consultation paper says that the Government proposes to legislate to exclude individual regulated firms from the FPC's powers. It is recognised in paragraph 2.29, however, that the FPC's macro-prudential interventions may be aimed at a small number of large institutions – perhaps only one or two - that could pose systemic risk. The paper does not propose any specific way of addressing this but merely says that the FPC will need to be aware of the potential for its activities to overlap with the regulators' own responsibilities for supervising individual firms and must take care to ensure that the firm-specific decisions continue to be taken by the line regulator. It is proposed, however, that the FPC be given a power to direct the PRA or FCA to implement measures imposed using the macro-prudential tools. There is no mention of the rights of firms to challenge such measures.

Paragraph 2.97 differentiates between two types of use of the FPC's power to direct. High level directions requiring the PRA or FCA to use their discretion to

determine how the FPC's aim can best be achieved are contrasted with the very specific use of the direction making power, requiring no discretion whatsoever on the part of regulators to implement it. Some of the macro-prudential interventions proposed could (if they were effected by the FSA under the current law) require the use of its FSA OIVoP powers under section 45 of FSMA if aimed at one or two institutions. In that event, an affected firm would have the right to refer the matter to the Tribunal. It is not clear precisely what (if anything) the Government is proposing here in relation to the rights of firms. If the PRA or FCA are given no discretion whatsoever by a direction of the FPC, then it appears unlikely that a firm would be able to challenge the measures implemented by the regulator in compliance with that direction. We imagine that any attempt to bring judicial review proceedings against the FPC would be met by the argument that its actions are not justiciable on the grounds that they concern matters of economic policy, notwithstanding that they affect very few firms. And in any event it appears unlikely that a court would be prepared to second-guess the FPC on matters within its expertise, taking into account the high threshold in actions for judicial review. However, the less discretion that is accorded to the regulators and the more a "one size fits all" approach is adopted by the FPC in the use of its direction making power, the more important it is that firms have a proper right to challenge matters that affect them. The alternative (as mentioned in paragraph 2.97) would be for the directions of the FPC to be expressed broadly and be binding on the PRA and the FCA as to the overall outcome to be achieved. The regulator would then have a discretion as to how it acted but firms would (we assume) have the same safeguards as apply currently. We consider that this approach is preferable and that the FPC should be required to use it unless giving the PRA or FCA a discretion in the particular case would be prejudicial to financial stability.

We broadly agree with the proposals in paragraphs 2.94 to 2.97 in relation to consultation. It is important to financial institutions, their investors and their counterparties that there is as much clarity as possible in relation to how the FPC's powers may be used. We note, however, that there will not necessarily be a requirement on the FPC to consult on a policy statement in advance of using a particular tool. It is proposed in paragraph 2.94 that the Treasury should specify, when setting out the FPC's toolkit in secondary legislation, whether the FPC should publish and consult on a policy statement in advance of using the tool and whether existing PRA and FCA procedural requirements should apply when implementing that tool. We do not agree that the secondary legislation should set out on a once and for all basis that there will, say, be no consultation whatsoever on certain uses of the direction making power. We would be concerned that this could lead to an approach whereby the more

coercive the tool is, the fewer safeguards would apply. The argument would be that such a tool would only be exercised in an emergency and it would be prejudicial to financial stability at that point for the authorities to have to comply with procedural safeguards. We see no reason why following enactment of the legislation the FPC could not be required to consult on a policy statement in relation to the use of all of its tools. In the case of the power to direct, it could be required to consult on a policy statement in advance of using the power, subject to an exception where the delay would be prejudicial to financial stability. The same would apply to consultation by the PRA and FCA. As set out above, we do not consider that systemic risks build up overnight. The presumption in relation to consultation should in our view be that procedural requirements will generally apply unless the circumstances genuinely warrant a departure from the norm, based on objective and predefined criteria.

It is recognised in paragraph 2.75 that the mechanism for creation of an ad hoc tool will rarely – if ever – need to be used. It is not clear from paragraphs 2.72 and 2.73 precisely how the mechanism would be used. Paragraph 2.72 refers to the possibility of the PRA or FCA refusing to comply with a recommendation of the FPC because they do not have the power to carry out the action proposed or because they believe that it would have significant unintended consequences. In the case of the latter is not clear whether the solution proposed in paragraph 2.73 would also involve extending the powers of the PRA or FCA in order to give them the legal powers to comply with the direction. We hope that is not what is being suggested. The creation of an entirely new tool, without warning, would be a radical step and potentially prejudicial to financial stability in itself. The ability to extend regulators' legal powers at the same time would be highly damaging to legal certainty.

Question 1 - What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?

Question 2 - Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?

We do not consider that we can comment on the likely effectiveness of the macro-prudential tools generally without greater detail as to their scope and operation.

We note that the proposed tools are very specific but that they are to be focused on system-wide, rather than firm specific, characteristics. However, as mentioned above, we note that the Government accepts that, in practice, a macro-prudential intervention may be aimed at a very small number of systemic

institutions. This seems to us to present a tension. Measures aimed at a very small number of institutions but applied on a "one size fits all" approach may operate unfairly. Different firms could be affected in different ways, perhaps disproportionately, by the same measure. However, if directions are focused very narrowly, there is a risk of the FPC assuming the role of the regulators. Paragraph 2.53 refers, for example, to the possibility of targeting capital requirements specifically on certain sectors or assets, recognising that correctly identifying the source of the risks would be an information-intensive process. In our view, this underlines that the FPC should generally be required, when exercising the power of direction, to give the regulators discretion as to how they implement the FPC's aim in using the particular tool in relation to individual firms.

There is very little in the Consultation Paper on how the arrangements would work where the power of direction is used in such a way that the PRA or FCA have no discretion. Complying with measures imposed by the PRA or FCA as result of the direction by the FPC may not necessarily be easy to implement quickly by affected firms. In some cases, they may be subject to contractual obligations that prevent them from doing so. For example, setting haircuts at a particular rate in repo transactions may require a UK authorised firm to breach its contract with a counterparty who is not subject to the same requirements. We are assuming that there is no suggestion that measures implemented in response to directions would have an impact on existing contractual arrangements.

3. PRUDENTIAL REGULATION AUTHORITY

Question 5: What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?

The formulation of a clear strategic objective is essential in setting the context for the scope of the PRA's rule making and other powers, particularly given the lack of clarity elsewhere in the paper as to what should be regarded as prudential matters falling within the remit of the PRA and what should be considered as conduct matters to be dealt with by the FCA. Accordingly, we agree with the principle of having a clearly expressed set of objectives and with the general concept of setting out factors to which the authorities should have regard, rather than expressing these as secondary objectives.

However, we question the formulation of paragraph 4 in Box 3A. It seems to us incorrect to say that promoting the safety and soundness of PRA authorised persons "includes" seeking to minimise any adverse effect that failure of that

person could be expected to have on the UK financial system. Rather, even if the PRA had failed to ensure the safety and soundness of an authorised person, it would not have failed in its strategic objective to the extent that the effect of that person's failure was minimised. Accordingly, it would seem preferable for paragraph 4 to be set out as a separate operational objective. Furthermore, it seems odd that the PRA does not have an obligation to advance its strategic objective but merely to act in a way that is compatible with it. We consider that it would be preferable to state that the authority is obliged to advance its strategic objective through either or both of its operational objectives.

In relation to the proposed regulatory principles:

- in relation to principle 3, we question the use of the word "general", which is not used in relation to any of the other principles. If there is any particular implication to be read into the use of the word here but not in principles 2 and 6, we consider that it should be stated explicitly;

- we do not consider that principle 5 (making information relating to authorised persons available to the public) is appropriate to be stated as a regulatory principle. Although this may be an appropriate tool to use in particular circumstances (as to which we comment in response to question 14 below), it does not seem to have the status of a general principle to be borne in mind generally by the authority in advancing its objectives. Underscoring this point, the use of the expression "in appropriate cases" makes the principle so vague and discretionary as not be helpful either as a guide to the authority or as a means of holding it to account;

- we consider that principle 6 should be expressed more strongly as a general obligation to exercise functions transparently, subject to a limited exception indicating the types of circumstances that would justify non-disclosure;

- we would urge the Government to reconsider its conclusion not to include as a principle the desirability of facilitating innovation. Although we recognise that some consider that undue weight may in the past have been given to this objective in its current form in section 2 of FSMA, we do not consider that this is a good reason for omitting the principle altogether. Without such a principle, it will be difficult for supervisors to give any weight to the benefits for users of financial services of new products and services, as against any risk to firms or consumers that they may pose. Clearly there is a need to weigh the risks against the rewards, but to omit the principle altogether indicates that the rewards are simply not taken into account. We suggest

that the principle should be included but reformulated, for example by referring to encouraging the development of a financial system and markets which respond to the needs of their users.

Question 6: What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?

We are concerned that the decision as to whether to subject an investment firm to the supervision of the PRA is to be taken by the PRA itself. There is a clear conflict of interest in permitting the PRA to determine the scope of its own jurisdiction in relation to particular firms. We also wonder what procedures there would be for conversion of a firm from FCA to PRA supervision (for example, how would the PRA obtain the necessary information to determine whether it considered that a firm had become suitable to be supervised by it and how would differences of opinion between the FCA and the PRA be dealt with?). Instead, we would favour a quantitative rather than a qualitative test that would eliminate the need for discretion to be exercised.

We consider that certainty of approach is the most critical issue for firms which have permission to deal as principal. We therefore prefer a clear and objectively certain test, and this test does not need to bear close relation to whatever ends up as being the internationally agreed test for identifying SIFIs.

In relation to the proposed threshold for investment firms being eligible for supervision by the PRA, we suggest that a "full scope BIPRU investment firm" would be a more appropriate category than a "BIPRU 730k firm" as being one of the conditions for a firm to fall under the PRA, thereby excluding, for example, limited activity firms. In addition we think there should be a balance sheet test to set an appropriately high threshold. We think the benefits of certainty outweigh the risk that a few firms may become subject to the PRA who arguably are not systemically important.

We think that the test should be clear and objective, and that the PRA should be required to supervise firms which meet the conditions, otherwise the certainty of an objective test is undermined.

It will also be necessary to avoid changes of regulator as balance sheets expand or contract. We suggest using an approach similar to that in the Conglomerates Directive so that for example, a firm which crosses the threshold will be treated as continuing to do so for a period of no less that 1/2/3 years

regardless of whether in fact it crosses back during that period. Such an approach provides the firm and the PRA with certainty.

Question 7: What are your views on the mechanisms proposed to make the regulator judgment-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on more limited grounds for appeal)?

Although we support the principle of the PRA taking a judgment-led approach, we have a number of concerns about some of the mechanisms proposed to achieve this. In particular:

- use of principles rather than rules: the use of principles rather than rules, the purposive application of those principles and requiring compliance with the spirit rather than the letter all come with the cost of reducing the certainty available to authorised firms as to whether or not their actions are compliant. We appreciate the desire to avoid a "tick box" approach to regulation and for the authority to maintain sufficient flexibility to exercise its judgment where appropriate, but a regulatory system that is fit for purpose and reflects best practice needs to provide authorised firms with a clear view of the standards expected of them and provide for firms to be treated with due process. We consider that this requires an underlying body of rules which are coherent and susceptible to interpretation according to a well understood body of precedent or guidance.

  Moreover, we question how this approach will operate in an environment where most rulemaking is carried out at an EU level and increasingly by way of Regulation rather than Directive. Although we agree with the proposal for statements of purpose to be included with rules that are made by the PRA, we question the extent to which it will be possible within the framework of EU legislation in relation to rules that implement Directive/Regulation provisions.

- more limited grounds for appeal: we are very concerned by the proposal to limit the grounds for appeal against supervisory decisions. The process of making supervisory decisions should be regarded as a quasi-judicial rather than an administrative process. The decisions taken may have major implications for firms and individuals. Individuals who are refused approval will always have to declare this fact on other applications, even though in many cases the reasons will not be to do with issues of integrity or reputation. Thus the exercise of the authority's decisions is capable of having fundamental effects on firms and individuals, such as their ability to

carry on particular types of business (in relation to decisions on authorisation and variation of permission) or to be employed in the financial services industry (in relation to approval of individuals to perform controlled functions). A judgment-led approach in relation to matters of this type should not imply that the authority can exercise discretions subjectively, without regard to the underlying principles and objectives of the rules that are being applied. The authority's exercise of judgment should accordingly be subject to appropriate checks and balances. Is not right to give the PRA greater discretions and then take away recourse. Such a framework is not justified , we do not see judicial review as a real option and the very existence of a framework under which decisions can be reviewed imposes a valuable and necessary discipline on those taking the decisions. We regard the existing framework under FSMA, which provides for a reference to the Tribunal, as an appropriate safeguard which has the advantage of being backed by an existing body of learning and practice. We do not think that restricting a right of appeal to a judicial review –style process would provide a meaningful safeguard, given the very limited grounds on which a challenge can be made. We would also question the compatibility of a general restriction of this type with the European Convention of Human Rights. At the least, we would urge the Government to consider distinguishing between those types of decision that would remain subject to the current right of referral to the Tribunal (in particular, decisions relating to the approval of individuals to perform controlled functions and decisions relating to the authorisation of firms and the scope of their Part IV permissions) and other supervisory decisions that would be subject to a more limited right of appeal.

- the PIF: The purpose behind the proposed Proactive Intervention Framework is only briefly alluded to in the paper, but it seems to be intended as a precursor to the resolution of a failing institution. There is stated to be a presumption that, once a firm is placed within the PIF, some form of regulatory action will be taken. Given the apparently severe consequences of falling within the PIF, we consider it important that appropriate safeguards are placed around the trigger for a firm to be placed within it, both in terms of defining sufficiently tightly in legislation or rules the circumstances in which this can happen and in terms of the process by which the trigger can be exercised by the PRA. Furthermore, thought should be given to measures to ensure that the fact that a firm has been placed within the PIF does not become public (for example, by making appropriate amendments to the Disclosure and Transparency Rules and by overriding

contractual disclosure obligations), since this may lead to a loss of confidence in the firm.

Question 8: What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

We suggest that more attention should be paid to the management of conflicts between the PRA and the Bank and its Financial Policy Committee – for example, in the situation where the PRA is considering whether or not to comply with a recommendation made by the FPC.

Question 9: What are your views on the accountability mechanisms proposed for the PRA?

We do not consider that these proposals raise specifically legal issues.

Question 10: What are your views on the Government's proposals for the PRA's engagement with industry and the wider public?

We agree with the Government's proposals that there should be no significant reductions to the existing requirements to consult set out in FSMA. Nevertheless, we have some concerns as to what is implied by the use of the word "significant". We also question the formulation of the exception to the PRA's obligation to publicly consult as being "where to do so would be prejudicial to its objectives". We would prefer a more focused and limited exception, referring specifically to the need for urgency. If there is sufficient time to consult, we find it hard to see a justification for not consulting based on the authority's objectives since one of the key purposes of consultation, as the paper itself points out, is to ensure that a proposed regulatory intervention is indeed justified by reference to the authority's objectives and the principles.

In the context of an approach under which the PRA will make greater use of principles, we would also flag the importance of consulting on principles and any associated guidance issued by the PRA as well as on rules made by it.

The paper states that the Government will give further consideration to the question of whether the requirement to consult could be streamlined when implementing EU rules. In our view, the Government should be cautious in diluting the consultation principle in such cases. Even when implementing rules made in primary or secondary EU legislation, there remain important functions to be carried out at national level as to the method of implementation (copy out or something further), the consequential effect of new rules on existing legislation and regulation and the provision of guidance. Consultation on these

matters is likely to improve the quality of decision making , reduce the likelihood of inadvertent and unintended consequences and improve firms' understanding of the context and implications of the new rules.

In relation to the proposals to clarify how proportionality will be applied in relation to the cost-benefit analysis of proposed new rules, we would point out that, even in cases where it is not possible to monetise or quantify costs and benefits, it will still be appropriate to identify clearly the failure that any new rules are designed to address and the likely effectiveness of the rules in curing that failure in order to justify a regulatory intervention.

We also agree that the PRA should be under a duty to make and maintain arrangements for consulting practitioners on its policies and practices.

4. FINANCIAL CONDUCT AUTHORITY

Question 11: What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

As noted above, we support the formulation of clear statutory objectives. We suggest that paragraph 1 Box 4.A be amended to read:

"In discharging its functions the FCA must, so far as is reasonably possible, act in a way which:

(a) is compatible with its strategic objective, and

(b) advances one or more of its operational objectives."

Presumably the operational objectives are not expected to be exclusive.

We support the broad definitions of 'services' and 'consumers'.

With respect to the regulatory principles to which the FCA (and the PRA) must have regard, as noted above clarification is sought as to why Principle 3 is phrased as "the general principle". If this principle is in some way different to the other principles, it would be beneficial if this could be spelt out. If it is on the same footing as the other principles, we consider it desirable to delete the word "general".

As noted above we do not consider that Principle 5 is appropriate as currently drafted.

Question 12: What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

We support the proposed arrangements for governance and accountability.

Question 13: What are your views on the proposed new FCA product intervention power?

The FCA's proposed product intervention powers are broad ranging. We note the Government's recognition of the need to strike a balance between enabling the FCA to act quickly to protect consumers and provide appropriate certainty for firms. We agree that the proposed product intervention powers will need to be very clearly defined and circumscribed, and we support the notion that the principles be designed to give clarity and certainty to the industry with respect to the FCA's expectations in relation to product design and product governance. With respect to the concept of proportionality, we agree that such powers are likely to be inappropriate in relation to professional or wholesale customers. Whilst we reserve judgement on the specific powers until such time as the consultation on the set of principles which will govern the use such powers is published, we do have the following comments which we hope may inform the Government's thinking in advance of that consultation.

The definition of 'product' is critical and will require careful consideration as this will, presumably, underpin the product intervention regime. The triggers for intervention will also need to be clearly specified, as will the scope of any particular product banning order. For example, if the banned product is present or embedded within a different type of product (for example, within a UCITS Fund) what will the effect of the banning order be? Will the UCITS fund be banned entirely, or will the fund be prohibited from investing in the particular product? What if the product is embedded within another product that the fund invests in, such that the fund has an indirect exposure to the banned product? It is proposed that legislation be introduced to make provision for the unenforceability of contracts made in breach of product intervention rules. What is to be done in respect of products that are sold in advance of a banning order? Will firms be expected to make refunds to clients that have already invested in or bought such a product, and if so, will clients bear the risk and reward of any market movement during the time between acquisition of the product and its banishment, or will the client be refunded the amount of his original investment? How will TCF obligations be viewed where customers have invested in such products?

The characteristics of a particular product that are objectionable will need to be clearly identified, not least because various instruments can have very similar outcomes, even though structured quite differently.

We note the statement that the product-banning power does not represent a move towards product pre-approval. However, given the costs of product development, and the potential damage to regulatory and commercial reputation in the event of powers of intervention being utilised, we would expect firms to seek a dialogue with the FCA as products are developed or altered to comply with banning orders.

Question 14: The Government would welcome specific comments on:

(a) the proposed approach to the FCA using transparency and disclosure as a regulatory tool;

(b) the proposed new powers in relation to financial promotions;

(c) the proposed new powers in relation to warning notices.

These are the most controversial and objectionable elements of this chapter in the consultation paper. We support the proposal that the FCA be open in disclosing its views on market developments (e.g. trends in products or services) and what it observes by way of firm behaviour, both good and bad. However, we consider that this can be achieved without unduly prejudicing the reputation of regulated firms. We do not consider that enabling the regulator to communicate with consumers about the remedial action it is taking, in order to increase the visibility of the actions of the regulator, outweighs long standing legal principles, including the presumption of innocence and the right to have an opportunity to present one's case.

The consultation paper states that the Government will ensure that any new powers contain the necessary safeguards to ensure that an appropriate balance is struck between interests of consumers and regulated firms. If the Government proceeds with its proposal we strongly suggest that a further opportunity be given to comment on the proposed legislation. Contrary to the FCA's strategic objective of enhancing confidence in the UK financial system, inappropriate powers could in fact lead to a lack of confidence in the UK financial system if there is a rush to early and potentially prejudicial disclosures.

(b) The proposed new powers in relation to financial promotions

The proposals could result in significant reputational and commercial damage to firms for potentially relatively minor breaches. We do not agree that providing evidence of the action that the regulator is taking in relation to financial promotions is a sound basis for justifying the disclosure of specific information that is likely to be unduly prejudicial to a particular firm. If the objective in publishing the fact that the regulator has asked a firm to withdraw a misleading promotion is to increase confidence in the FCA's ability to protect consumers, increase regulatory accountability and engender better practice across the industry, FCA could, for example, publish periodic anonymous data detailing the number of promotions that have been referred, the number reviewed and that it has requested be withdrawn, possibly by reference to product types or sectors. It could also highlight good and bad practices.

The current proposals suggest that a firm will be named even if it does not contest the FCA decision, such that all requests to withdraw financial promotions will be published. If this is the case, it is likely to encourage firms to launch appeals in order to avoid negative publicity resulting in increased costs for the industry, and depletion of the resources of the FCA. There can be situations where a firm might disagree with the FSA but the firm is prepared to agree to a request to change or withdraw a promotion. The attitude might be very different if the firm were to face having its name published and be to the overall detriment of the supervisory relationship. We understand that there is a balance to be struck and would suggest that rather than publishing the name of all firms requested to withdraw financial promotions, only serial offenders are named and shamed.

(c) The proposed new powers in relation to warning notices

We strongly object to these proposals and urge the Government to reconsider its stance. We do not consider that giving a regulator the power to disclose the fact that a warning notice has been issued is justified on the basis that it highlights potential issues to consumers and signals to firms examples of behaviour that the regulator considers to be unacceptable.

A warning notice is a step in a process, warning notices are highly selective as to their content, omit relevant material which does not assist the case on which the FSA wishes to rely and are issued before the firm or individual has had access to the material which the FSA has in its possession or an opportunity to challenge what the notice says. If the regulator has a case then it will appear in due course and it is at that point that the world is aware of the conduct that has

been found to occur and the regulator's view of it. Not every warning notice results in a Decision Notice. If a warning notice is published and there is no subsequent Decision Notice there is no public disclosure of why serious allegations have not been sustained, leaving a stain on a firm's or an individual's reputation. This is a stark contrast to a criminal process (which we do not think is an appropriate analogy but is one we have heard advanced) in which prosecution evidence is tested in the public gaze. In addition, in our experience, even when a warning notice is followed by a Decision Notice, the content is often materially different.

Nor do we consider that increasing the visibility of the actions that the regulator is taking to protect consumers interests to be a sound basis for introducing such measures. Indeed if as can be the case it subsequently appears that there were serious mistakes in the warning notice, or the case does not proceed as the regulator's enforcement team would wish, there is a considerable downside for confidence in the regulator.

Notwithstanding the Government's acknowledgement of the dangers inherent in such a proposal, and the proposed safeguards, we strongly diasagree that this will ensure procedural fairness for affected firms and individuals. In light of the commercial and reputational damage likely to be caused by the publication of such notices, procedural fairness can best be ensured by retaining a right to be heard and make representations prior to any publication of a notice. We consider that the highly prejudicial impact to regulated firms and individuals far outweighs any benefit to consumers and the regulated community, if indeed there is any such benefit. In simple terms, a significant punishment will be meted out to an individual or to a firm prior to any form of judicial process. The regulator has many other tools available to meet the objectives of highlighting behaviour that the regulator finds unacceptable, for example, in publications like Market Watch, Dear CEO letters, speeches and use of intervention powers. As currently envisaged, the proposals could be construed as a breach of natural justice, given that affected firms and individuals will not have the opportunity to refer the proposed publication to a third party, nor have their representations in relation to such disclosure heard. Further, the proposals dangerously shift the burden of proof towards a guilty until proven innocent stance.

As with the proposed powers in relation to financial promotions, we suggest that many of the Government's objectives could be achieved by way of publication of anonymous data. In this way consumers can be made aware of potential issues, and signals can be sent to firms regarding the behaviours deemed to be

unacceptable. We urge extreme caution in taking steps that undermine important principles of judicial process.

As a general comment we see great value in the continuation of a body like the Regulatory Decisions Committee and we would be concerned if there were proposals that would materially alter its status or operating methods.

Question 15: Which, if any, of the additional new powers in relation to general competition law outlined would be appropriate for the FCA? Are there any other powers the Government should consider?

We support the concept of the FCA having a stronger role in competition than the FSA has had to date. We would welcome the opportunity to comment on the more detailed proposals to be published following BIS's review of concurrency.

Question 16: The Government would welcome specific comments on:

(a) the proposals for RIEs and Part XVIII of FSMA; and

(b) the proposals in relation to listing and primary market regulation.

These proposals for the most part seem sensible. However, we would not characterise the extension of the UKLA's powers to impose sanctions on sponsors for breach of UKLA rules and requirements as a minor technical improvement. Further information on the nature and extent of such powers is required before any further comment can be made.

5. REGULATORY PROCESS AND COORDINATION

Question 17: What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

5.1 General comments

We are broadly supportive of the proposed mechanisms and processes to support effective co-ordination between the PRA and the FCA. Effective coordination between the two authorities is clearly a fundamental concern for dual-regulated firms which, if not properly addressed, will create significant operational dysfunctionality in the day-to-day supervision of these firms. While the proposed statutory duty to co-ordinate, obligation to prepare a Memorandum of Understanding (MoU) and cross-membership of boards by the two Chief Executives, undeniably represent steps in the right direction, they provide only an outline framework on which fully fleshed out processes for

effective co-ordination will then need to be devised. As the Treasury recognises in paragraph 5.28 of the Consultation, it will be the detailed day-to-day arrangements worked out by the two authorities that will underpin the legislative framework and ultimately determine if effective co-ordination is delivered in practice.

In view of the perceived difficulties associated with the practical operation of the current Tripartite Arrangement, we think it is vitally important that HM Treasury, the FSA and the Bank give considerable thought to the way in which effective co-ordination between the PRA and the FCA will be achieved on a day-to-day basis and seek the views of market participants on the proposed day-to-day arrangements to achieve this outcome. Ultimately, this will require the right culture to be established within each authority from its inception by its Chief Executive and senior management, whose relationship with their immediate counterparts will obviously need to be close, particularly in areas involving high anticipated levels of potential overlap and co-working. Each Chief Executive should convey the paramount importance of a culture of co-operation between the two authorities, with significant emphasis on ensuring synergies at all levels of their respective organisations. Crucial in this regard will be the steps taken in the early days, particularly the arrangements being put in place to establish a shadow operation ahead of the formal establishment of the PRA and the FCA. It seems to us that the new arrangements will be doomed to failure if staff from the two authorities are unwilling or unable to work together because of operational failures within the PRA and the FCA.

We think it is important that there is proper public consultation in relation to the detailed practical arrangements relating to the proposed division of regulatory responsibilities between the PRA and the FCA. In this regard, we welcome the statement that the Bank and the FSA will publish papers providing further details of these arrangements. Full public consultation on these issues is crucial to ensuring market confidence in the new regulatory arrangements.

5.2 Statutory duty to co-ordinate

We agree that it is preferable for the PRA and FCA to have a statutory duty to coordinate, rather than a statutory requirement for each to "have regard to" the other's objectives (as proposed in the July 2010 consultation document). It is vital that there is absolute clarity with regard to each regulator's responsibilities as regards all of the regulatory powers and processes set out in the Financial Services and Markets Act 2000 (FSMA) and the rules included in the FSA Handbook of Rules and Guidance. For this reason, we think there is considerable merit in responsibility for all regulatory processes and decisions

relating to dual-regulated firms being clearly set out in primary legislation. Restricting the scope of primary legislation to particular processes and decisions (as suggested in paragraph 5.9 of the Consultation) heightens the risk of uncertainty for the PRA, the FCA and financial market participants and increases the risk of disagreement between both authorities.

We have the following specific comments regarding the proposed statutory duty to co-ordinate:

- We are unclear as to whether the use of the terms "materially impact" and "where necessary" in the first and second limbs is intended to denote a subjective or objective standard. It would be important for the PRA, the FCA and market participants to have greater clarity regarding the circumstances in which consultation would be expected between the two authorities in the ordinary course, it being a mistake to set the bar at which consultation is required at too high a level.

- It seems to us that there should be an express statutory requirement for each authority to use its best endeavours with due regard to urgency when discharging its duty to co-ordinate.

- We strongly support the proposal that the third limb should require each authority to ensure that processes involving both authorities are managed congruently and efficiently. In particular, the PRA and the FCA should endeavour to exercise their powers on a joint basis in relation to the same dual-regulated firm in order to reduce regulatory burdens and potential regulatory arbitrage. We think there is a strong case for the statutory duty to co-ordinate to require each authority to manage the risk of a failure of effective co-ordination by ensuring that it has appropriate systems and controls to identify and remediate actual or potential breakdowns in co-ordination.

- We believe that the third limb should specifically require each authority to avoid duplication and otherwise reduce unnecessary burdens on dual-regulated firms. This outcome would clearly be highly beneficial for dual-regulated firms and would reduce the overall costs incurred by each authority in discharging its duties.

5.3 Memorandum of Understanding (MoU)

We are supportive of the proposal that primary legislation will require an MoU to be agreed between the PRA and FCA covering a non-exhaustive list of matters.

It is key that the MoU should be a full and detailed articulation of the framework for co-ordination and consultation between the PRA and the FCA.

We agree that the list of matters to be included in the MoU should be non-exhaustive on the basis that this will give the two authorities flexibility to include matters in the MoU that were not anticipated at the legislative stage, and to make amendments over time. We believe that the MoU should address the following matters not mentioned in paragraph 5.13 of the Consultation:

- Areas of common interest (in addition to how the roles of the PRA and the FCA are distinct).

- How the PRA and the FCA will avoid duplication in practice.

- How the PRA and the FCA will work together in relation to the proposed use of regulatory powers, changes in regulatory policy or guidance and regulatory decisions which are likely to impact the other authority.

- The circumstances in which information provided by dual-regulated firms to the PRA or the FCA will be shared with the other authority. In particular, dual-regulated firms will need to know the circumstances in which information provided to one authority will be treated as satisfying any obligation to provide the same information to the other authority. In this regard, we think it is important that both authorities accept the principle that notifications made by dual-regulated firms under the PRA and FCA equivalents of Principle 11 of the FSA's Principles for Businesses need only be made by the firm to the authority that it considers to be the most appropriate recipient in the circumstances.

- When and how the PRA and the FCA will carry out joint supervisory visits and inspections of dual-regulated firms.

- How the PRA and the FCA will consult to set regulatory fees and levies.

We agree that the MoU should be reviewed annually and are supportive of a requirement for the MoU to be laid before Parliament whenever changes are made on the grounds that this will provide a degree of external scrutiny. By way of additional external scrutiny, we think that each of the PRA and the FCA should be required to include a statement in its annual report setting out how the statutory duty to co-ordinate and related matters covered by the MoU have operated in practice over the relevant time period.

5.4 Cross membership of boards

We are supportive of the proposal that the Chief Executive of each of the PRA and the FCA should sit on the board of the other authority. We believe that it would be appropriate to restrict the Chief Executive of the FCA from voting on firm-specific decisions made by the PRA (and vice versa).

Question 18: What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?

We understand that the proposed power of veto in favour of the PRA is intended to be limited in nature. That said, the existence of this power would appear to orient the balance of power between the two authorities in favour of the PRA and thereby play to perceptions that the PRA will in practice operate as the senior regulator. Indeed it seems to us that inappropriate or heavy handed exercise of the power of veto by the PRA will be likely to sully relations with the FCA, heightening concerns regarding future disagreements and failures to ensure effective co-ordination.

As a result, it is important that there is a greater degree of clarity regarding the limited circumstances in which the power of veto is likely to be exercisable by the PRA in practice. This will ensure that there is less scope for disagreement between the PRA and the FCA and will provide market participants with a clearer picture of the circumstances in which the power of veto could be exercised in practice.

Where a situation arises in which the FCA's actions may lead to the disorderly failure of a firm or wider financial instability, it would clearly be preferable for the PRA to discuss its concerns and endeavour to reach a solution with the FCA, consistent with the first limb of the proposed statutory duty to co-ordinate.

We agree that there should be an appropriate degree of transparency around use of the power of veto. We are supportive of the proposed legislative safeguards, although we are not clear if the proposed laying of the notification of the veto before Parliament is intended to take place before or after the power has been exercised (and would ask that this matter is clarified). Further clarity should be certainly provided in relation to the way in which considerations of public interest could affect the normal process of notification of the veto before Parliament.

We will provide more detailed comments on the proposed power of veto once the draft legislation is available for comment.

Question 19: What are your views on the proposed models for the authorisation process – which do you prefer and why?

5.5 General comments

We agree that it is important to ensure that the authorisation process is both practical and efficient for applicant firms, and should not present inappropriate disincentives for firms wishing to enter the financial sector. As noted above it is also important for the competitive position of the U.K. Whilst this should be an objective for all firms, it is especially important to consider how this objective can be achieved for dual-regulated firms for whom there are likely to be considerable challenges in this area. As such, it is particularly important that the PRA and FCA co-ordinate effectively on matters relating to the authorisation process to minimise the potential pitfalls for dual-regulated firms.

Before commenting on the specific proposals outlined in the Consultation, we wish to point out the desirability of a potential approach not mentioned in the Consultation involving the use of a shared services function to provide a common back office for both the PRA and the FCA and a single application process for authorisations and approvals required for dual-regulated firms. If implemented correctly, this would address the concerns of market participants regarding the risk of duplication, would engender the co-operative working relations required to ensure the effective supervision of dual-regulated firms and would lead to a more efficient use of the resources of each authority. In light of this, we would strongly urge the Treasury to give serious consideration to the introduction of a shared services function for the PRA and the FCA.

Regardless of which model is adopted for the authorisation process, we consider it strongly desirable on the grounds of transparency for a single register of authorised firms and approved persons to be maintained for all firms along the lines of that currently operated today by the FSA. While a single register would naturally complement our suggestion that a shared services function be introduced for the PRA and the FCA, we see no reason in principle why it could not be introduced under each of the proposed models for the authorisation process suggested in the Consultation.

5.6 FCA regulated firms

We agree that the FCA should operate the authorisation process for those firms for which it is the sole regulator in much the same way as the existing Part IV process under FSMA.

5.7 Dual-regulated firms

In the case of dual-regulated firms, we note the Government's intention to give the authorities powers to designate sole or lead jurisdiction for one authority under each of the threshold conditions. We are concerned about the current lack of clarity regarding the arrangements for designating sole or lead jurisdiction under each of the threshold conditions. In particular, how will this designation take place and what will happen if the two authorities are unable to reach agreement? In practice, many of the threshold conditions are likely to be relevant to both authorities so it will be crucial for market participants to understand how these arrangements will work where one authority has been accorded lead jurisdiction in relation to a given threshold condition. We would urge the Treasury to provide further clarity as to the practical arrangements surrounding the threshold conditions for dual-regulated firms.

On the assumption that the Government decides to proceed with one of the two approaches to authorisation suggested in the Consultation, our strong preference would be for the alternative approach to be adopted in preference to the lead proposal. This reflects the fact that the alternative approach is likely to achieve a higher level of co-ordination and efficiency between the PRA and the FCA and will more closely replicate the existing 'one-stop shop' arrangements for obtaining authorisation from the FSA under Part IV of FSMA. It also reflects concerns about how the lead proposal would operate in practice, notably the inherent bureaucracy, inefficiencies and concerns about duplication that would be associated with a dual application process.

Our view is that the FCA should be responsible for processing all applications for dual-regulated firms under the alternative approach (on the basis that it would have to seek the consent of the PRA) rather than for this responsibility to be accorded to the regulator with prudential responsibility for the activity at the centre of the application. This approach acknowledges the fact that the FCA will in any event be responsible for processing the majority of authorisation applications relating to firms for which it is sole regulator. It also recognises the value of developing a centre of authorisation excellence within a single regulator and the potential difficulties that may arise in deciding whether some applicants would be prudentially regulated by the PRA or the FCA.

In view of the fact that the consent of both authorities will be required in order to progress an authorisation application under the alternative approach, particular attention should be paid to the co-operation that would need to take place between the PRA and the FCA in order to allow issues to be debated and resolved. A shared services function along the lines mentioned above would be particularly helpful in this regard and would seem to us to be a natural complement to the alternative approach. (We are assuming, as we hope is the case, that there will continue to be a single criminal law perimeter).

We think it would be highly undesirable for the alternative approach to become associated with a lack of transparency in relation to the application process, bearing in mind the inevitable background dialogue that would need to take place between the PRA and the FCA. In particular, any concerns of the authority which does not have responsibility for processing the authorisation application should be made known to the applicant. Likewise any reasons given for refusing an application or imposing limitations or conditions on an authorisation should be made clear to the applicant and be subject to a suitably transparent appeal process.

Whichever approach is adopted, firms must be given clear expectations of the time limits for processing authorisation applications and appropriate service standards should be applied. In particular, it is important that the time taken to review an authorisation application does not exceed the current statutory time limits and service standards applicable to the FSA under the current authorisation regime. In this regard, it would be extremely unfortunate from the point of view of the competitiveness of the UK as a place in which to establish a financial services business if the new authorisation process adopted for dual-regulated firms was significantly more time consuming, complex and costly than the equivalent authorisation process or processes applied by regulators in other EU member states. We suggest that consideration is given to imposing an automatic "approval" if an application has not been approved or formally entered the warning notice process within a prescribed time, at least for approved person applications , otherwise the statutory time limits are of little impact as they can be ignored by the regulator with impunity. In any event there must be published service standards and a means of holding to account for breach of them.

Question 20: What are your views on the proposals on variation and removal of permissions?

We note the Government's view that both regulatory authorities should be able to impose requirements that affect the nature of a firm's permission, in

accordance with their strategic and operational objectives. While we accept this basic premise, we think it is important that appropriate distinction is drawn between an Own Initiative Variation of Permission (OIVoP), a Voluntary Variation of Permission (VVoP) and a cancellation of permission.

As you aware we have expressed concerns before about the OIVoP regime. As the Government clearly intends to keep the regime we agree in principle that the PRA and the FCA should each be able to exercise OIVoP powers similar to those currently exercisable by the FSA. In the case of dual-regulated firms, both authorities should be subject to a statutory duty to consult the other and reach agreement before any exercise of OIVoP powers. We think it is important that any exercise of OIVoP powers by either authority is subject to appropriate safeguards and controls, similar to those applicable to the FSA today under the existing FSMA regime.

We take the view that the procedures for VVoP and cancellation of existing PRA or FCA permissions should mirror the alternative approach and should involve the FCA processing the associated applications and obtaining, in the case of dual-regulated firms, the consent of the PRA to the proposed variation or cancellation.

Question 21: What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?

We agree with the Government's proposal that the FCA should have full power to designate controlled functions for those firms for which it is sole regulator and to approve individuals to undertake those functions, in each case on a similar basis to the current approved persons regime under FSMA.

We are very concerned about the apparent lack of clarity regarding the Government's proposals for the approved persons regime for dual-regulated firms. These concerns relate to the overarching principle that lead responsibility for controlled functions should be split between the PRA and the FCA in line with their objectives.

The proposals for dual-regulated firms envisage that the PRA would lead on designation and approval of all controlled functions connected to the prudential soundness of a regulated firm on the assumption that it would consult the FCA where it has an interest but would have the final say on the approval decision. In practice, we imagine that many of the existing controlled functions will be relevant in one way or another to both the prudential soundness of a dual-regulated firm and its interface with customers. Either way, the expectation is

that dual-regulated firms should make applications to both the PRA and the FCA and that there would be considerable behind the scene discussions between the two authorities.

It seems to us that the approved persons regime for dual-regulated firms should be rationalised along the lines of our preferred approach to the alternative approach discussed above. Under this arrangement, all approved person applications would be submitted to the FCA for processing and the FCA would seek the PRA's consent in relation to the approval of any controlled function connected to the prudential soundness of the firm. This would seem to us to simplify what would otherwise be a potentially cumbersome and duplicative twin track application process.

For any such arrangement to work in practice, the PRA and the FCA would be required to reach agreement on how the approved persons regime should operate, including which of the current controlled functions concerned only the PRA, only the FCA or both. Of particular relevance here would be any arrangements for the interview of candidates for approval to perform significant influence functions, which are likely to concern both the PRA and the FCA and, where an interview is involved, should involve a single interview attended by representatives from both authorities.

It is vital that the timeframes for processing approved person applications should not increase in order to take into account the regulatory changes and that the PRA and the FCA should adhere to the same statutory time limits and service standards as the FSA.

Question 22. What are your views on the Government's proposals on passporting?

We agree that the FCA should have responsibility for the passporting process and administrative oversight of firms which have established branches in the UK under the passport.

We have some concerns about the practicalities of how the passporting process will work for dual-regulated firms wishing to establish branches in other EEA Member States under the passport. The suggestion in the Consultation is that there will be a separation of responsibility for dual-regulated firms, with the PRA being responsible for issues relating to financial soundness and the FCA being responsible for all conduct issues. There is no discussion of how this separation of responsibility would operate in practice. However, our clear preference would be for all such passport notifications to be received by the

FCA on a centralised basis and for a single form of notification to be used. This assumes that the FCA would seek the PRA's input on issues relating to financial soundness.

Although paragraphs 5.50 to 5.53 of the Consultation do not make this clear, we assume that the FCA will be responsible for receiving passport notifications relating to the outbound provision of services on a cross-border basis by UK authorised firms and the inbound provision of services on a cross-border basis by EEA authorised firms.

Question 23: What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?

We imagine that mutual organisations will be concerned that the Government has dropped the requirement for the authorities to have regard to the need for diversity in providers of financial services. We take the view that the proposal that the PRA and the FCA must carry out a cost-benefit analysis of how consultation proposals will affect mutually-owned institutions is a poor substitute for a "have regards" requirement enshrined in legislation. It also falls short of the Government's commitments in the Coalition Agreement to foster diversity in financial services and promote the role of mutuals.

Whilst mutual organisations may take some comfort from the fact that the FCA does at least have the promotion of competition in its objectives, the PRA does not.

Question 24: What are your views on the process and powers proposed for making and waiving rules?

5.8 Rule making

We agree that the PRA and the FCA should have a statutory power to make rules that apply to regulated firms within their jurisdiction. However, in relation to dual-regulated firms, we are very concerned about the potential implications of the division of the current integrated FSA Handbook of Rules and Guidance into rules that are PRA specific, FCA specific or common to both. In practice, we imagine that there will be many instances where the PRA and the FCA would wish to adopt the same FSA rules as part of their initial rulebooks, with FSA rules relating to systems and controls and the FSA's Principles for Businesses being obvious examples.

In light of this, we think that there is a strong case for the PRA and the FCA to make joint rules in the areas in which they would both wish to exercise their

rule-making powers. Failing this, each authority should establish its own rules committee whose membership would include representatives from the other authority so that matters relating to common rules could be properly debated. Either arrangement would need to be underpinned by detailed co-ordination regarding the practical day-to-day application of any joint or common rules to dual-regulated firms, bearing in mind the crucial importance of avoiding unnecessary duplication and resolving any potential conflicts that may arise. This arrangement would inevitably have to recognise that each authority would wish to apply these rules in a manner that reflected its own specific objectives and its particular areas of expertise.

Of particular relevance are the FSA's current prudential rules set out in its GENPRU and BIPRU sourcebooks, which represent the UK implementation of EU prudential requirements. Both the PRA and the FCA will have significant responsibilities as prudential regulators and will be applying the same or similar prudential requirements to the firms they regulate. It is therefore important that both authorities recognise the need for consistent interpretation of these common prudential requirements and can justify any differences in their practical application on the basis of the differing business activities carried on by the firms that they regulate from a prudential perspective. Going forward, similar concerns would apply to other EU requirements implemented by the PRA and the FCA through joint or common rules.

While we welcome the suggestion that the FPC should play a role in resolving any conflicts that emerge between the PRA and the FCA, we note that its role would be limited only to disagreements relating to the authorities' assessment of the impact of a rule on financial stability. This does raise the important question of how conflicts would be resolved in relation to other types of disagreement between the PRA and the FCA. We would regard a process to resolve these types of disagreement as an indispensible component of the new regulatory regime and would urge the Treasury to give serious thought to the inclusion of a suitable process in the new legislation.

The duty of the PRA and the FCA to consult the other prior to making rules applying to the same functions within individual dual-regulated firms should also apply to any guidance (whether formal or informal) or statements of purpose (in the case of the PRA) relating to these rules. This reflects the paramount importance of avoiding situations in which conflicting messages are given to dual-regulated firms in relation to the application of the same or similar regulatory requirements.

5.9 Rule waivers

We agree that each authority should be able to consent to the modification or disapplication of the rules that it makes and that, in the case of a dual-regulated firm, the authority wishing to issue a consent should consult the other before issuing a direction approving an amendment or modification.

We note that, in the case of firms which are prudentially regulated by the FCA, the FCA would be required to consult the PRA if it considers that the proposed action could threaten financial stability, with the PRA being able to exercise its right of veto on these grounds. We think it would be a mistake to perceive the FCA as the "junior" partner in prudential regulatory matters in the case of these firms. In practice, the FCA will develop a considerable body of prudential regulatory expertise in relation to a broad range of financial sector firms, including some firms of significant size who, by virtue of their business activities, would never fall to be prudentially regulated by the PRA. In view of the PRA's focus on dual-regulated firms undertaking particular types of business activity, we think it is only right and proper that the PRA should pay close attention to the views of the FCA regarding the prudential regulation of other types of firm.

Question 25: The Government welcomes specific comments on:

- *proposals to support effective group supervision by the new authorities – including the new power of direction; and*
- *proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?*

5.10 Group supervision

We agree with the basic premise that, where 'solo' prudential supervision of firms within the consolidation group is split across the PRA and the FCA, the authority responsible for consolidated supervision should have a power of direction over the other authority. However, exercise of the power of direction should be a last resort option, bearing in mind the desirability of the two authorities being able to achieve a workable approach to consolidated supervision through prior consultation. In this regard, we agree that an authority should be under a duty to consult with its counterpart before a direction can be issued. We also agree that the power should only be available where a consolidation group exists under EU law and that it should be exercisable only where necessary to ensure effective consolidated supervision.

It is unclear from the Consultation if affected firms would receive early warning of the potential issue of a direction by the PRA or the FCA. We do think it is highly desirable for there to be a level of transparency to affected firms before the point at which they receive a copy of a direction.

It is important that the Treasury recognises that there will be circumstances in which firms will have a legitimate interest in ensuring that public disclosure of a direction does not take place. We therefore look forward with interest to receiving further details of the circumstances in which disclosure would be capable of being withheld in the public interest and the related procedures.

We note the contents of paragraph 5.72 of the Consultation, specifically the comment that the new authorities will be able to exercise discretion to carry out consolidated supervision with reference to the wider group so that the latter is effectively subsumed into supervision of the group as a whole. The exercise of this discretion should take into account any power of direction that an authority may have over unregulated holding companies and should be carefully exercised in practice. We would be very concerned if in practice this were to produce a different outcome for firms than that which arises today.

We are unclear how the proposed UK specific arrangements are intended to relate to arrangements with regulators in other EU member states regarding consolidated supervision issues and would ask the Treasury to give further thought to this issue.

5.11 Unregulated holding companies

We have some concerns regarding the proposed power of direction over unregulated parent undertakings which control and exert influence over authorised firms. Our main concern is the apparently low threshold at which the power becomes exercisable, namely where the authority considers it desirable for the purposes of fulfilling its statutory objective. We think that the exercise of this power should be an exceptional event and that this should be reflected in the conditions under which it is exercisable in practice. In this regard, we do think it is important that the power is exercisable only where all other available regulatory tools have been exhausted in relation to the relevant authorised firms.

Whilst we welcome the proposal to give a notice warning of the potential application of a power of direction, the devil will very much be in the detail of the process and the remedies that may be available. We are unclear why an

unregulated person should only have a right of appeal to the Upper Tribunal rather than a right to a de novo hearing.

We would ask the Treasury to confirm if the PRA's power of veto would apply to circumstances in which the PRA or the FCA is required to consult with its counterpart prior to issuing a direction affecting a dual-regulated firm or a group which includes such a firm.

We welcome the proposed publication of a statement of practice outlining how the power of direction will be exercised and look forward to responding to the consultation on the further details of the proposed power and the related safeguards.

Question 26: What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?

5.12 Change of control

It is highly desirable for all change of control applications to be submitted to a single regulator. We are therefore concerned that the effect of paragraph 5.80 of the Consultation would be to require applications to be submitted to each of the FCA and the PRA in the case of a proposed change of control involving a group that included dual-regulated firms and firms which are prudentially regulated on a solo basis by the FCA. We think that this approach would be duplicative and cumbersome for market participants.

Consistent with our earlier comments, we feel that the FCA should be responsible for the receipt and processing of all change of control applications. This is on the assumption that the FCA would be under a statutory duty to consult the PRA in the case of dual-regulated firms. Adopting this approach would simplify the process for applicants and facilitate the use of a single application form for all approvals. It would also complement what we assume would be the lead role given to the FCA in bringing civil and criminal enforcement proceedings in relation to alleged breaches of the change of control regime.

In the case of dual-regulated firms, it seems to us that the rather complicated mixture of circumstances in which the PRA's views would take precedence over those of the FCA (or vice versa) has clear potential to create tension between the two authorities. This risk re-emphasises the great importance of effective co-ordination between the two authorities.

5.13 Part VII transfers

We agree with the comment that the current arrangements for transfers of insurance and banking business under Part VII of FSMA "work well" insofar as it relates to the Part VII mechanism of transferring business under a court-approved scheme. Our principal concern is therefore to ensure that the proposed regulatory reforms do not have a detrimental impact on the operation of the Part VII transfer mechanism.

The Consultation proposes that the PRA should take the lead on all Part VII applications. Whilst it is difficult to set any rules about which of the FCA and PRA will be most interested in a particular transfer, the FCA could perhaps be expected to have the greater interest on life transfers, with the PRA more in the lead on general/reinsurance transfers. We doubt the sense of the PRA leading on a Part VII transfer of life business, especially one involving with-profits business, where matters relating to Treating Customers Fairly are key, including in communications to policyholders. The key thing for insurers is that the Part VII mechanism should be clear and should not introduce yet more delay for clients. It would certainly be preferable to have a single process (albeit involving consultation between the two authorities) rather than two parallel processes.

Question 28: What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

While this question is primarily of concern to industry, we are supportive of the proposal to collect fees for both the PRA and the FCA through one organisation under a non-statutory arrangement.

We agree with the Treasury that it will be essential for the PRA and the FCA to use their resources efficiently in order to control their costs. This is inevitably one of the driving factors underlying the need for effective co-ordination between the two authorities. In particular, we believe that an approach involving a single application for authorisations and approvals being submitted to the FCA in the case of dual-regulated firms would be likely to involve significant cost savings.

6. COMPENSATION, DISPUTE RESOLUTION AND FINANCIAL EDUCATION

Q.29 What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?

As we mentioned in our response to the August 2010 HM Treasury consultation paper on Financial Regulation, we consider that engaging in a micro-debate on the mechanics of operating and co-ordinating supervision of the Financial Services Compensation Scheme ("**FSCS**") at a time when European dispositions may be imminent and major policy decisions have yet to be taken is to risk creating a square peg for a round hole.

Nonetheless, it now appears that decisions will need to be taken about FSCS governance before the fundamental policy issues are resolved. We therefore look at (i) the role of the FSCS and the effectiveness of its pre-crisis operating model, coordination and governance, (ii) the lessons to be learnt from the recent crisis and (iii) the ways in which the FSCS may need to develop; (iv) we then set out our conclusions on the consultation questions above. These conclusions relate to the new legislation to be introduced very shortly and it may be difficult, at this stage, to anticipate and provide for the different ways that the FSCS functions may develop in the future. It may therefore be necessary to revisit these issues once the EU requirements/schemes are settled and conclusions have been reached on domestic policy for the FSCS schemes or their replacement.

(i) The role of the FSCS and the effectiveness of its pre-crisis operating model, coordination and governance

The FSCS obviously has an important systemic role as one of the safeguards which contribute to confidence in the financial system. For example, it was intended to increase depositor confidence and act as a break against a run on an individual deposit taker or a broader run on a group/herd of stressed banks or building societies. None of the authorities, however, (individually, or collectively as the tripartite,) made a realistic assessment of how the FSCS would meet this financial stability objective. In an echo of the broader position in relation to prudential regulation, that has prompted the coalition government's new approach to regulation, there was no realistic stress testing of the FSCS.

It was clear even in the early stages of the crisis that the FSCS deposit insurance protection was flawed, in systemic terms, (despite the fact that FSA had very recently consulted on and redesigned the FSCS (including the introduction of a new single scheme)). These flaws included – the uninsured share (90:10), the extent of coverage, the insured capacity compared to the size of the insured deposits, and the financial strength of the scheme (compared to its capacity/potential liabilities).

In addition there was a lack of clarity (and, therefore, lack of understanding) about the position of insured depositors. Most fundamentally, this uncertainty related to the position of the government/state (in another echo of the broader prudential position); depositors were uncertain whether the FSCS capacity was state guaranteed and whether, when aggregate claims exceeded that capacity, the government would step in to ensure insured depositors claims were met. There were many further areas of uncertainty – e.g. the position of depositors who also had client money on deposit at the same bank as a direct deposit. Other events, including the large levy on firms for the Keydata failure, have revealed many difficulties with interpreting and applying the FSCS current rules.

(ii) The lessons to be learnt from the recent crisis are

- There is a substantial macro-prudential/financial stability dimension to the FSCS role.

- The precedent of leaving FSCS design solely to the front-line micro-prudential regulator(s) (which the government appears to envisage following) is not a good one.

(iii) The ways in which the FSCS may need to develop

The crisis has prompted a wide ranging debate about FSCS type schemes. Although changes have already been introduced in the UK, for example to facilitate fast pay outs, it is difficult to predict today what the EU/UK schemes will look like in a few years time. There are substantive questions of macro-prudential policy still to be resolved and one can envisage from the current debate that there may well be major changes in the structure, scope and funding of the schemes and potentially fundamental changes in the institutions responsible for the new schemes. There are new bodies (FPC and ESRB) being established with a key policy role in this area and it may be some time before their views are known.

The single scheme established by FSA may well be broken up. It is possible that some elements could be replaced by an EU level scheme or arrangement. There may well be pre-funded schemes. The pre-funded Federal Deposit Insurance Corporation (FDIC) in the US is a very different animal to the current FSCS. It is an insurer with substantial premium income and with substantial financial resources; no doubt it has governance arrangements that reflect this. It is therefore very difficult, and probably impossible, to construct an 'operating model, coordination arrangements and governance' to fit all the different

outcomes in the UK (which necessarily depend on the arrangements and requirements at the EU level).

(iv) Conclusions

We suggest that the proposed operating model, coordination arrangements and governance for the FSCS (as set out in the current consultation) do not take sufficient account of

- the macro-prudential role of the FSCS function.

- the lessons to be leant from the recent crisis where the precedent of leaving FSCS design solely to the front-line micro-prudential regulator(s) did not work well and led to the failure to reach a balanced and realistic view on the role of the FSCS at a systemic level and in the context of the financial stability objective.

- the ways in which the FSCS (or parts of it) may need to develop in accordance with domestic policy or to meet EU requirements.

Our recommendations -

- As the body responsible for macro-prudential regulation, the FPC should have a recognised role in relation to (if not outright responsibility for) the overall design of FSCS type protection/funding (or at least for the systemically significant schemes (such as depositor protection) which emerge from the current single scheme). The design necessarily involves other macro-prudential issues/measures such as resolution arrangements and RRPs, capital and bail-ins etc ; it is paramount that a proper balance is struck and the FPC seems best placed to evaluate these issues and report on them.

- We doubt whether this macro-prudential role of the FPC can be achieved simply by the general power it will have to give directions to the micro-prudential regulator(s) - PRA (and FCA).

- The FPC could also deal with the issue of the state's role as a potential last resort provider of emergency protection/liquidity (a role that the UK government had to take on during the crisis – as FSCS funder/guarantor and in providing protection beyond FSCS limits), just as it will presumably look at the Bank of England's/the state's role (however limited) as the last resort provider of emergency liquidity and capital to the banking sector itself.

- We believe that it is vitally important that a proper balance is struck when setting the capacity, funding and scope of FSCS type schemes between the macro-prudential and financial stability objectives on the one hand and, on the other hand, the costs to firms (and therefore to consumers) of funding this insurance and their contingent liability to levies. The scheme design must be addressed according to a balanced objective. We believe this balanced objective should be recognised in the new arrangements and that all proposals for change should be subject to full consultation and cost benefit analysis in this context.

- Once the design, structure, capacity and funding of the scheme(s) has been determined, the operation will be a matter for the FSCS and the micro-prudential regulators. In that context we support statutory duties on PRA and FCA to co-ordinate in these matters as well as the publication of MOUs both between PRA and FCA and between FSCS and the two regulators.

Question 30: What are your views on the proposals relating to the FOS, particularly in relation to transparency?

We support the view that the Financial Ombudsman Scheme ("**FOS**") should remain an alternative dispute resolution service. We also agree that the role of FOS is to provide access to swift and impartial resolution of disputes between firms and customers, free to consumers to use, as an alternative to the courts.

However, we believe that the consultation paper misses a key point with regard to FOS. Whilst we shall comment on transparency below, this is not the main issue requiring clarification. Instead, the main issue is how FOS is going to function. There is a need for an overdue policy debate about the nature of the role of FOS.

'Swift and impartial' resolution of disputes cannot be allowed to mean decisions that are unpredictable and on occasion without any sound basis. The current role of FOS is to apply the law in relation to jurisdiction and to take account of the law in its decisions on merits and redress, within its fair and reasonable remit. We believe, though, that FOS has taken on the character of a secondary regulator in the retail /consumer world, making compensation awards in individual cases on the basis of a subjective view. These awards are then regarded as a form of precedent and can result in the requirement to provide compensation retrospectively across a significant part of the firm's business, even to customers who did not complain, because of a firm's wider obligations and TCF obligations. This in effect can impose an unpredictable backdating of

applicable standards, or impose new standards, on the financial services provider.

We consider that FOS should be obliged to apply the law in all instances, be constrained to take decisions in accordance with a clear set of rules, including those derived from European legislation. Financial services providers need to have certainty and the security of knowing that if they are compliant with applicable current rules and guidance and/or relevant legal principles, FOS will not have the discretion unreasonably to find against them. This is particularly important given that there is no appeals process from a FOS Final Decision; such a decision can have a substantial impact, including financial effect, on a firm and its business.

The consultation paper stresses the need to keep the roles of FOS and the FCA separate. However, joint operation could facilitate consistent application of the rules. Closer co-ordination is not currently working. There is no legal reason why FOS should not be part of FCA. Within this, FOS should focus on its function of dealing with individual disputes on a case by case basis, but under the oversight of FCA, whose role would be to ensure that the standards it applies are consistent with FCA's own published rules and standards. This would address the inconsistency, damaging for firms, of FOS decisions setting a precedent for FSA-regulated firms, while at the same time FSA says that FOS is operationally independent and not subject to its jurisdiction.

Addressing the specific question of transparency, whilst we note the Government's aim of clarifying the position with regard to the publication of decisions, we are uncertain as to the exact which makes it difficult to comment. For example, what is meant by publishing 'in a proactive and coordinated way'? It appears that the Government wishes to allow FOS to publish determinations 'if it considers it appropriate to do so'. In other words, FOS will be able to set the rules on this and decide if and when to apply them, with merely an 'expectation' that there will be some unspecified consultation on these principles.

We do not agree with the approach in this particular instance. We do not support publishing decisions on individual firms generated by complaints to which firms have no effective possibility of responding. We acknowledge the conclusions of the recent Hunt Review of FOS which focused particularly on transparency and accessibility, but do not understand why the Government would give FOS such wide discretion. The thrust of policy elsewhere within the financial services regulatory regime appears to be on imposition of rules by the regulator. Both complainants and financial services firms need to have just as

much predictability and transparency in the matter of publication of determinations as they do for the determinations themselves. We consider that it would be unacceptable to leave the choice of publication entirely to FOS, particularly given that the 'fair and reasonable' procedure applying to such decisions is wide and subjective. We propose instead that, in so far as the UK has freedom to set rules on this rather than being bound by EU legislation, the principles for publication of decisions are set by the FCA after the usual statutory consultation.

Question 31: What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?

We support the requirement that publication of an annual plan by FSCS and FOS, as well as by the CFEB, be made a statutory duty, with associated consultation requirements. We also support the proposed responsibility of the National Audit Office for ensuring that these three bodies are carrying out their functions in an efficient and economic way.

The involvement of the National Audit Office must sit alongside the responsibilities of the FCA and/or PRA for ensuring compliance of these organisations, particularly FSCS and FOS, with the legal principles underpinning their functions.

7. EUROPEAN AND INTERNATIONAL ISSUES

Question 32: What are your views on the proposed arrangements for international coordination outlined above?

We welcome the recognition by HMT of the need for effective engagement between the proposed UK regulatory authorities and the new European supervisory bodies and the need for co-ordination between the UK authorities in this context. In particular, we agree with the comments in paragraphs 7.13 and 7.14 about the importance of such co-ordination given the fact that the conduct of business/prudential divide cuts across the work of the ESAs. We refer to our comments on Chapter 5 in relation to the MoUs between the UK authorities.

We would welcome the establishment of a statutory MoU between the Treasury, Bank of England, PRA and FCA on overall international coordination within the UK system and would suggest that it may be appropriate for high level principles akin to those contained in Chapters 5.11 and 5.13 (Regulatory processes and coordination) to be contained in the MoU.

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

Yours sincerely

Margaret Chamberlain

Margaret Chamberlain
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