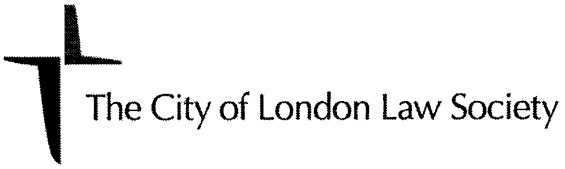

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8 September 2011

Dear Sirs

Re: CLLS Regulatory Law Committee response: A new approach to financial regulation: the blueprint for reform

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 the HM Treasury Consultation on "A new approach to financial regulation: the blueprint for reform" has been prepared by the CLLS Regulatory Law Committee (the **"Committee"**). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introduction

The publication of the White Paper and the draft legislation has provided some more information as to how the Government sees the new regulatory infrastructure, but, taken in the round, the draft legislation provides a scant framework for a fundamental reform which will replace a "tripartite" model of financial regulation with one which has four regulatory bodies. Efficient and effective interaction and co-ordination between these bodies will be critical. This is not only to ensure a 'safe' system of regulation, but also to reassure regulated firms that they will neither be paying for an inefficient duplicative system, in particular one which requires them to provide broadly the same information to more than one regulator, nor at risk of being caught in a cross fire of disagreement or perimeter disputes between regulators. In a crisis situation the interaction between the various bodies will be critical. In particular, we would highlight the following as areas where more detail is required in the primary legislation:

- We do not think that the draft legislation provides adequate underpinning for the interaction between the regulators. The new arrangements are scarcely more clear and binding than the existing tripartite arrangements and involve considerable reliance on an inter-regulator Memorandum of Understanding, and this does not inspire confidence. The objectives of and the fundamental elements that must be covered by any Memorandum of Understanding between regulators should be stated on the face of the legislation, or in secondary legislation. It should not be for regulators to decide what should be covered.

- Similarly, the regulatory scope of the PRA should be based on clear, transparent principles stated in the law; it should not be a matter for its discretion.

- The proposals split the regulation of exchanges from that of the clearing and settlement systems which settle the transactions executed on exchanges and lack clarity on the responsibility for settlement finality designations.

There is also a real risk that the structure will decrease the effectiveness of the U.K. voice in Europe at a time when there has been a considerable shift of power to the European regulatory bodies. There must be much more clarity as to how the regulators will interact to provide a coherent and effective European voice, as it is our understanding that although there are effectively four regulators, the U.K. has only one seat on each European Supervisory Authority.

We are also concerned that the proposals include substantial extensions of enforcement processes and publication of decisions with little protection for the regulated person, for example:

(1) directions in respect of financial promotions: there does not appear to be any prior consultation (or other process engaging the authorised person) before the FSA gives the direction and publishes it;

(2) publication of a warning notice requires only that the target person(s) be consulted and sets some criteria of substance for a decision not to publish - but again neither sets out or requires any additional process or protections.

Indeed, the amendments proposed further dilute the protections that already exist in relation to the giving of warning notices, decision notices and supervisory just as the potential effect of such actions is being magnified by changes such as the two referred to, above. There will continue to be no requirement for the regulator to consult on the statement of procedure it is required to issue under section 395(5). At the very least in light of the changes proposed, the regulators should have to consult, but more than that, Treasury should be required to set minimum standards for such procedures.

We repeat below some of the comments we have made previously, even though they have not yet been taken into account. Where we do so this is because we consider the matter to be one of considerable importance, whether because it raises fundamental issues of natural justice and fair procedure and/or because it has negative implications for the position of the U.K. as a financial centre compared with other major European cities.

Box 2.A: Consultation question

1 Do you have any specific views on the proposals for the FPC?

As set out in our response dated 14 April 2011 to the consultation "A New Approach to Financial Regulation – Building a Stronger System" (CM8012) we express no view on the creation of the FPC as a matter of principle. We note that the draft Bill reflects very closely the proposals in the previous consultation and for that reason some of our comments set out below are very similar to the comments we made in our April response.

The FPC's proposed objective and Treasury control

The FPC's objective links into the Bank of England's revised financial stability objective of protecting and enhancing financial stability in new section 2A of the Bank of England Act 1998. In the absence of a detailed definition of "financial stability", we consider that the provisions of the Bill referred to below make insufficient provision for Treasury control and contain insufficient constraints on the FPC.

Section 9A(2) provides that the Bank's Court of Directors must consult the Treasury about a draft of the Bank's financial stability strategy but is silent about the weight to be accorded to any recommendations made by the Treasury. We consider that this should be made explicit, probably by a "comply or explain" provision of the type included elsewhere.

New section 9(C)(1) provides only for the FPC to exercise its functions "with a view" to contributing to the achievement of the Bank of the Financial Stability Objective. This appears to suggest that the FPC may potentially have other objectives in mind as well so long as its aims include contributing to the Bank's Financial Stability Objective. In any event, it appears to set the FPC a very low target to meet (though we generally welcome the requirement in section 9S(4)(b) for a financial stability report to include an assessment of the extent to which the FPC has succeeded in meeting its objectives).

We note that in proposed new section 9(C)(4) the Government has proposed a balance between financial stability and sustainable economic growth in the terms set out in Box 2B of the previous consultation. The new provision, by its breadth and subjectivity, grants the FPC a wide measure of discretion to exercise its functions in a way that may have a significant effect on the UK's economic development. We remain of the view that the latitude accorded to the FPC is too wide.

While the Treasury may at any time make recommendations under new section 9(D)(1) as to matters the FPC should regard as relevant to its understanding of the Bank's Financial Stability Objective, its responsibility in relation to the achievement of that objective or matters to which the FPC should have regard in exercising its functions, the FPC is not required to comply with the Treasury's recommendations. It is simply under an obligation to notify the Treasury whether or how far it accepts the recommendations and what action (if any) it proposes to take in response to them. We note also that no provision is made for the Treasury to make recommendations about matters which the FPC should not regard as relevant. We consider that the Treasury should expressly have this power. While in practice the FPC may generally follow the Treasury's recommendations, we consider that greater weight should be accorded to the Treasury's recommendations on the face of the Bill and, in

this regard, we note the disparity between the Treasury's powers in relation to the FPC and the FPC's powers in relation to the PRA and FCA.

Finally, we note that in section 9E(1) in the exercise of its functions the FPC must "have regard" to the Bank's financial stability strategy. When taken together with the provisions referred to above, we consider that this creates uncertainty about the full extent of the FPC's functions and the controls over it.

Exercise of functions

From the point of view of the regulated financial services community there is likely to be uncertainty as to the extent to which statements or indications by the FCA or PRA as to future regulatory policy can be relied upon in view of the ability of the FPC to override them. Section 9(A)(2) provides for the FPC to strike a balance between contributing to the achievement by the Bank of the Financial Stability Objective and the advancing by the FCA of any of its operational objectives or the advancing by the PRA of its objectives. However, the provision strikes a balance in such a way that it is likely to enable the FPC to override the FCA and the PRA. The Bill contains a number of provisions for communication or consultation between the various public bodies subject to the provisions of the Bill. There is, however, in this case no mechanism provided by which the FPC will take into account the views of the PRA and FCA in striking a balance between the Bank's Financial Stability Objective and the objectives of the PRA and FPC. The absence, for example, of a duty to consult renders it unclear how the FPC will assess the existence and extent of any potential prejudice to those objectives.

As we have previously commented, the provisions in relation to proportionality (found in new section 9(E)(3)) omit certain elements of the requirement. The formulation of proportionality does not include the requirement that a measure should generally go no further than necessary in order to achieve the legitimate aim being pursued. Furthermore, the provision gives no guide as to how the balance should be struck and who should be taken into account for the purpose of assessing the benefits that are expected to result. Finally, the obligation of the FPC under new section 9(E)(3) is only to "have regard" to the matters set out in that provision. The effect is that the obligation on the FPC to act in a proportionate manner is weakly cast. It needs to be strengthened to give market participants confidence in the integrity of the FPC's exercise of its functions.

Strengthening the requirement in relation to proportionality would give greater comfort that the FPC will exercise its functions in a graduated way. At present, there is no express provision as to how the FPC will choose which of its various powers it will exercise. In this regard we note that in relation to directions by the FPC under new section 9(G), an order by the Treasury under new section 9(K) may, in relation to a prescribed type of measure, require the FPC to maintain a statement of the general policy that it proposes to follow in relation to the exercise of the particular power of direction. Although the giving of directions by the FPC may be relatively rare, given the real consequences that are likely to flow from the making of a direction, we consider that new section 9(K)(4) should provide for the Treasury to be required to impose an obligation on the FPC to maintain a general policy statement in relation to the exercise of the direction-making power.

Accountability

Paragraph 2.28 of the previous consultation indicated that the Government proposed to legislate to exclude individual regulated firms from the FPC's powers, while recognising 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 a systemic risk. New section 9(G)(4) sets out that a direction may relate to all regulated persons or to regulated persons of a specified description but may not relate to a specified regulated person. While such provision is welcome, it does not really address the concern that the FPC may effectively stray into taking firm-specific decisions that are properly part of the functions of (most likely) the PRA. No provision is made on the face of the Bill in relation to the rights of systemically important institutions to challenge measures that are directed specifically at them. As noted in our previous response, some of the macro-prudential interventions proposed could (if they were effected by the FSA under the current law) require the use of its OIVoP power under section 45 of FSMA if directed at individual institutions (with the corresponding right to refer the matter to the Tribunal). In practice, given the wide extent of the FPC's discretion and the high threshold for successfully bringing an action for judicial review, there may be little that the relevant institutions may do to secure the accountability of the FPC. While we understand that the Government would be likely to have concerns if a delay in the FPC's directions being given effect could have adverse consequences for financial stability, we do not consider new section 9G(4) provides sufficient safeguards. In addition, we consider that at the very least there should be a general presumption under new section 9(H)(2) that where a regulator is complying with a direction by the FPC, the usual procedural requirements will apply – or, at least, they will apply unless there would be a serious risk to financial stability caused by taking time for consultation.

Similarly, we note that new section 9(J) gives the Treasury a discretion whether to publish a direction under new section 9(G). If a direction is not published, it may make it extremely difficult for those affected by the resulting measures put in place by the PRA or FCA to review those measures against the relevant provisions of FSMA applicable to them. The presumption under section 9(J) should be in favour of publication, with the possibility of suspending publication only for so long as is necessary in the interests of financial stability.

Box 2.B: Consultation question

2 Do you have any specific views on the proposals for the Bank of England's regulation of RCHs, settlement and payment systems?

Changes to the recognition regime

The changes to the Financial Services and Markets Act seem to us to produce quite wide ranging philosophical changes in relation to the status of recognised bodies. These changes are however given a very low profile and no real explanation in the accompanying text. Whilst we recognise that markets have developed since the recognition regimes were introduced, we believe that they are still important and we are unaware of any failings in those regimes of a kind which would prompt significant change to them. The consultation paper makes no reference to any such failings. Other countries draw regulatory distinctions between those entities that are part of the central infrastructure required for the successful operation of their markets (i.e. exchanges and clearing houses) and distinguish them in a number of ways from other firms. At a European level MiFID clearly recognises that regulated markets, central counterparty, clearing and settlement facilities are not the same as investment firms and makes fundamentally different provision in relation to them. We think that the UK is out of step with other jurisdictions if it seeks to reduce the status of its own recognised bodies.

Under the present law the FSA has a wide range of powers in relation to the recognised bodies, which themselves have some regulatory functions, as recognised by their immunity in connection with the exercise of those functions. We believe that a much fuller discussion of the proposed changes would be appropriate before any decision is made to make them. In particular, we question proposals that would subject such entities to the potential of financial penalties and public censure. Have there really been situations where the absence of these penalties or powers has caused an issue, or is it realistically anticipated that there could be any such possibility? It seems to us to send an entirely different message about the status of these bodies from that which has to date been conferred by "recognition" status.

The paper provides no insight into the reasoning behind any of the changes proposed. The effect of the new structure will also be to fragment the regulation of key parts of market infrastructure which are interdependent, yet there is no detail at all on how the Bank of England, which will oversee payment systems and recognised clearing houses, will interact with the FCA which will be responsible for recognised investment exchanges. We also note that recognised investment exchanges may themselves also wish to provide clearing services, as indeed they have done historically. Only last week the LSE was reported to be in talks to buy LCH Clearnet.

We believe that any further changes to the recognition regime should await European developments (including the proposed MiFID II, EMIR and CSD measures) and that there should be no change to the UK regime in the interim.

Clearing services

We were surprised by a number of references in the paper which seem to equate clearing services with central counterparty services. For example, the statement "CREST (currently an RCH although it is not a central counterparty)", implies that HM Treasury is adopting a much narrower concept of clearing than that which has applied in the UK to date and indeed, which applies internationally. The European Commission produced a paper some time ago which sought to define services provided within the clearing and settlement value chain. We broadly agree with the analysis in that paper. This states that:

> *"After the execution of buy and sell orders, transactions are processed in preparation for the transfer of ownership of the product and the fulfilment of all obligations. Depending on the institution providing this service, several additional services are performed, such as the netting of obligations to ensure fewer processes and cash flows, and in particular the evaluation and management of all relevant sources of risk in order to reduce the probability of failure to meet obligations.*
>
> *In most cases, this function is performed on different levels; firstly by trading parties for their clients, secondly at central counterparty clearing houses (CCP clearing) and thirdly its central securities depositaries (CSD/ICSD clearing)....with regard to the various different clearing levels, it has to be taken into consideration that the clearing performed by a CCP is different from that performed by a CSD. CCP clearing concentrates on trade management, position management, collateral and risk management, and delivery management...CSD clearing concentrates on validating and matching the delivery instructions; the result of which is forwarded to settlement."*

It is clear on this basis that the CREST operator carries on both a clearing and a settlement function, which has always been the view of the authorities, the fact that it is not a central counterparty is of no relevance to the analysis. We therefore consider that it is a recognised clearing house and should be regulated as such by the Bank of England. It is a critical part of UK infrastructure, according to its website over £3.3 trillion of securities are held and transferred through the CREST system. It is surprising therefore, given its importance to the UK infrastructure and the fact that it has been a recognised clearing house from the day it was established, that there should be any doubt as its categorisation or its regulation.

European representation

The FCA has the UK seat on ESMA. We think it is important that the arrangements for interaction between the Bank of England and the FCA in respect of recognised bodies be clarified, if the FCA is to have a role in relation to recognised investment exchanges but not recognised clearing houses. Yet there will be significant developments on the European front which could affect recognised clearing houses. It will be essential that the FCA is properly equipped to represent the UK on these issues.

Other comments

We have the following additional comments:

1. We support immunity from liability in damages for the operator of systems under the Uncertificated Securities Regulations. At present the mismatch between this and the recognised clearing house regime gives rise to legal uncertainty;

2. We support the new powers proposed in respect of payment systems

3. We do not think that Schedule 17A paragraph 8 can be correct, financial instruments are not traded on a recognised clearing house, trading has already occurred, and therefore the notion of suspending or removing a financial instrument from trading has no application in this context. We do not in any event consider that a recognised clearing house is an institution within the meaning of new section 313A.

4. It is not clear to us what the intentions are in relation to settlement finality designation, as currently the FSA is responsible for designating systems operated as a recognised investment exchange or recognised clearing house. There is a need to tie up settlement finality designation with the division of responsibilities between the Bank of England and the FCA.

Box 2.C: Consultation question

3 Do you have any comments on:

- the proposed crisis management arrangements; and
- the proposals for minor and technical changes to the Special Resolution Regime?

Crisis management

As indicated in our earlier response, there is a fundamental need for coordination across the authorities in a crisis management situation. Creating clarity of roles and a requirement to enter a memorandum of understanding are welcome first steps, but are insufficient on their own to create the conditions for effective coordination.

Statutory provisions and a change in structure are not sufficient conditions to coordinated crisis management however. Effective coordination of crisis management requires the authorities to ensure cooperation and mutual understanding – and more critically it involves careful preparation and planning.

The interaction between the Bank and the PRA in advance of a crisis situation will be key to how successfully it is resolved. The creation and role of the Bank of England Special Resolution Unit in the FSA Recovery and Resolution Plan pilot has been a useful first step to better coordination between the authorities, and to more considered preparation for crisis situations. It is clear that more needs to be done to prepare the authorities for future crisis situations. This is likely to include assessment and transmission of relevant information between PRA and Bank staff as a firm nears crisis; war gaming failures of specific firm failures; and engagement of Bank staff through the implementation of firms' recovery plans (to enable consequential amendments to resolution planning). Consideration might also be given to a programme of secondment between the PRA and SRU.

We necessarily defer comment on the quality of the memorandum of understanding until it is published.

Special Resolution Regime

We welcome the proposed changes to the Special Resolution Regime proposed in clauses 59, 61 and 62 and have no comments on these. As a general point we welcome the willingness of the Government to limit the override powers relating to trusts in section 34(7) of the Banking Act. However, we believe that the changes proposed to section 34(7) (the "trust override") leave too much latitude to the Bank.

There has been justifiable criticism of the trust override power: the power gives rise to considerable legal uncertainty on the part of market participants as to how (rights in) trust property would be affected on a resolution, and is not justified by the needs of the authorities. The purpose of the override is to enable transfer with minimal damage to contractual and property rights – either of trustees or beneficiaries – and it is right that the power should be strictly limited to what is necessary to enable that to occur. To this end the new proposed subsection (8) is welcome: but it should apply not just to subsection 34(7)(a) but also subsection 34(7)(b). Further, we would question whether it would ever be justifiable for the Bank to remove (terminate) the terms of a trust in the exercise of its powers: we would therefore suggest the deletion of the words "or remove".

The Prudential Regulation Authority

Box 2.D: Consultation question
4 Do you have any comments on the objectives and scope of the PRA?

Box 2.E: Consultation question

5 Do you have any comments on the detailed arrangements for the PRA?

Objectives and scope

General objective

We are pleased to note that section 2B(2) and (3) FSMA would in effect contain two distinct operational objectives concerning: (1) the promotion of safety and soundness of PRA authorised persons; and (2) seeking to minimise any adverse effect that the failure of a PRA authorised person could have. As mentioned in our response to the previous consultation (A new approach to financial regulation - building a stronger system) it is incorrect to say that the promotion of the safety and soundness of PRA authorised persons "includes" seeking to minimise any adverse effect that the failure of that person could have on the UK financial system.

However, we are disappointed that the objectives are expressed in such bland terms, indeed in words that connote duties, actions and performance rather than aims. Given the express terms of section 2F, which limits sections 2B to 2D to emphasise that the PRA is not required to ensure that no firm fails, we consider that its objectives should be expressed as such, by deleting the references to "promoting" and "seeking" in sections 2B(2) and 2B(3)(b), to leave:

- "the safety and soundness of PRA authorised persons" and
- "minimising the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system".

The latter is critical as the test of success is surely whether adverse effects were minimised rather than whether the PRA merely sought to minimise them.

We question also the term "safety" in the general objective (section 2B(2)). It is unclear from what kind of risk (financial collapse, crime, etc) PRA firms are to be safe and for whose benefit (consumers, shareholders, society at large). A term more focussed on the risks (such as "financial strength") or clarification of the relevant stakeholders would help.

One approach to consider would be to base the objectives on the text of section 2B(3) (a) and (b) and add an objective similar to the specific insurance objective:

- Securing an appropriate degree of protection for those who are or may become depositors or other consumers of financial services.

See further on this below.

Another substantial point arises from section 2B(4). We would submit that the reference to adverse effect should include some notion of materiality, either by qualifying the reference itself ("material adverse effect") or by clarifying inter alia that a mere increase of risk is not necessarily an adverse effect.

Insurance and additional objectives

We welcome the new section 2C FSMA concerning the PRA's insurance objective. However, we are concerned about several aspects arising from the relative priorities and scope of this and other objectives.

'Equal priority' between this objective and the general objective could lead to compromises that may not truly satisfy either objective. We note that the creation of additional objectives is envisaged under section 2D FSMA and it is therefore important that both the regulator and the market have a clear understanding as to how conflicts or inconsistencies between the objectives are resolved. Whilst section 2H envisages the PRA publishing guidance regarding the discharge of its own objectives, this obviously creates a conflict of interest in the PRA; and it would be better if further clarity were provided for in the primary legislation itself (or by Treasury in a statutory instrument). In particular:

- it should not be for the regulator to determine its own scope (even in consultation with the other – which in any event could still lead to conflict or inconsistency); and

- in any event it is not appropriate for PRA guidance to be capable of extending or curtailing the scope of such important provisions as objectives.

Given Treasury's power under section 3G to establish the boundary between FCA and PRA, and the affirmative resolution required, the exercise of article 2H powers under 2H(1)(b) should require consultation with Treasury. And, consistent with section 3G, the provisions should refer to "...its, or primarily its responsibility..."

Since a key focus of the reforms is stability, the insurance objective and any other "specified objectives" should be subordinate to the general objective except in two ways:

- in respect only of the *financial supervision* of insurance and reinsurance undertakings, Solvency II will require the main objective to be protection of policy holders and beneficiaries (article 27), but nevertheless that the financial supervisor duly considers financial stability (article 28);

- to the extent otherwise provided in an order passed by affirmative resolution.

There has been insufficient attention paid to the implications of the insurance objective for the general objective. For example, why should not deposit holders be expressly mentioned as a focus of protection? This reinforces the point made above, though we recognise that any broad objective should be conditioned to an extent by reference to prudential regulatory issues rather than issues within the FCA's purview.

As to the wording of the insurance objective in section 2C(2), we have two concerns:

- "contributing to.." is weak and bland in the same way as the "promoting" and "seeking" in the general objective: if "contributing" is intended to refer to the fact that the FCA may have some responsibility in this area, that should be made clear, otherwise the objective should be simply "securing..." and section 2F would ensure this would not be construed as implying no failure of an insurer or reinsurer;

- further clarification is required on the meaning of the term "appropriate degree of protection". One can read appropriate as 'proportionate'. What is clear is that this is

not the idea of policyholders' reasonable expectations which was a terminology used before FSMA. Here PRA guidance under section 2H, on how it will construe the objective, is critical, as is clarification that it excludes conduct issues which are properly the FCA's concern.

Regulatory principles

Innovation: We would again urge the Government to reconsider its position not to include as a principle the desirability of facilitating innovation. 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 they may pose. We repeat that the principle should be included and consideration given to its reformulation.

Mutuality: We welcome the 'diversity have regard to' provision contained in new section 138L FSMA concerning mutual societies. However, whether this will prove to be useful to mutual societies depends upon the level of detail that will be set out in the regulator's statement. We note that the legislation uses the words "significantly different" but it is not clear what exactly this means. If the Government is serious about promoting mutuality, we suggest that the desirability of promoting the development of mutual societies be added as a principle in section 3B.

Competition: We welcome the Government's action to update the existing competition scrutiny regime which will apply to both the PRA and the FCA. Whilst the Bill provides for a competition link to the FCA's strategic and operational objectives (new section 1B(4) FSMA) it is strange that there is no competition link in the case of the PRA's objectives or principles. Competition is a key issue in light of the plethora of prudential regulatory changes since the financial crisis (including those still to come).

Scope in relation to investment firms

With regard to investment firms, we would repeat the point made in our previous response that there is a clear conflict of interest in permitting the PRA to determine the scope of its own jurisdiction in relation to particular investment firms. Certainty of approach is the most crucial issue for firms that have permission to deal as principal. The test needs to be both clear and objective. This is so both for firms currently based in the U.K. and for overseas firms deciding where to base European or global headquarters. They need a clear answer as to what their position would be if they were to choose London. If their first encounter with trying to understand the U.K. regulatory landscape produces an impression of vagueness and subjectivity as to how they will be treated, they will opt for jurisdictions with clear transparent structures. We would submit in particular that:

- Since the express intention (as stated in paragraph 2.57 of the White Paper) is to capture systemically important investment firms, the Treasury should lay down criteria to assess this (as have been developed in other fora (such as the BIS/FSB) and jurisdictions (such as the US where, under the Dodd-Frank Act, the new Financial Stability Oversight Council has been consulting on factors to consider in respect of different types of financial institution). We note that the FSA has recently published a consultation paper concerning recovery and resolution plans and it is proposed that some of the larger investment firms be required to prepare such plans. Subject to the overriding need for proportionality, we suggest that the criteria for both (i.e. PRA regulation of investment firms and the need to prepare such plans) be the same. Unless clear and objective criteria are to be specified in the Act or a statutory

instrument, then the Act should set a clear and transparent process for determining whether any particular firm is required to be PRA-authorised.

- Minimum criteria for and at least some of the criteria comprising the "procedural safeguards" referred to in paragraph 2.58 of the White Paper should be specified in the Bill, and the Treasury should be delegated responsibility for making orders detailing them. Those orders should be subject to the affirmative resolution procedure. Again, the US has a defined process to designate particular non-bank firms as systemically important.

- Safeguards should include, for example, protection against a change of regulator more than once in any defined period (3-years, for example), unless there is a major and transformative change in the firm.

Detailed arrangements

The existing framework under FSMA, which provides for a reference to the Upper Tribunal, is an important safeguard which has the advantage of being backed by an existing body of learning and practice. We welcome the Government's decision not to narrow the grounds of appeal.

Whilst leaving the Upper Tribunal's scope of review of supervisory decisions unchanged, the Government has proposed to limit the course of action available to the Tribunal in the event that it chooses not to uphold the regulator's decision. Other than in limited situations, the Tribunal will not be able to substitute its opinion for that of the regulator as to the regulatory action to be taken. The Tribunal will instead be required to remit the decision back to the regulator with such directions as it considers appropriate in relation to a range of findings. Paragraph 2.66 of the White Paper suggests that the PRA will have some latitude when following an Upper Tribunal direction. However, this does not appear to be the case in the legislation as new section 133 (6)(b) FSMA provides that the regulator will receive a direction to reconsider and "reach a decision in accordance with the findings of the Tribunal." We would highlight two potential issues. Firstly, there is an inherent conflict of interest on the basis that the PRA will have an interest in minimising the Tribunal's changes to its original position. Secondly, there are costs and timing implications for firms that will have to renegotiate with the PRA once the Tribunal has made its decision.

In the context of an approach under which the PRA will make greater use of principles, we again flag the importance of consulting on principles and any associated guidance issued by the PRA as well as on rules made by it. We are pleased to note that the Government intends to mainly replicate the existing consultation requirements set out in FSMA. We are also pleased to see that the Government is also not making an exception from the consultation requirements for those rules originating from Europe.

However, the White Paper states that there may be instances where the PRA may prepare an 'analysis' of costs and benefits rather than an estimate, where such costs or benefits cannot be reasonably estimated or it is not reasonably practicable to produce an estimate (see section 137K(8) FSMA). Whilst we note the safeguard inserted into the section that the PRA must include a statement of opinion where an analysis is used, it is difficult to see a regulatory justification for this change and can only assume that it is a cost saving measure. In addition, we note that the Government still uses the word "significant" in new section 137K(5) and it is still unclear to us what precisely this means.

In new section 137K FSMA the PRA is required to consult with the Treasury and Bank of England concerning the adequacy of resolution plans. Having been consulted the Treasury or the Bank of England may notify the PRA that in their opinion the plan is unsatisfactory. We note that new section 137K(4) FSMA provides that the PRA is to only "have regard" to the Treasury and/or Bank of England opinion and may nevertheless still approve the plan. We would question exactly what the circumstances would be where the PRA would approve a resolution plan which has been previously rejected by the Treasury or the Bank. It is perhaps for consideration whether the Bank and/or the Treasury should only be involved in relation to systemically important financial institutions where public money is at risk.

We refer to paragraph 2.68 of the White Paper dealing with the governance of the PRA and new schedule 1ZB FSMA. Paragraph 18 provides that the PRA must maintain satisfactory arrangements for recording decisions made in the exercise of its functions and for the safekeeping of records that it considers ought to be preserved. The PRA's record keeping requirements will be a particularly important aspect of its governance and we query whether "satisfactory arrangements" are sufficient. In a judgement based approach to supervision there will be a greater need for the PRA to record in sufficient detail the reasons for its decisions. Indeed it should be required to do so. Records of previous decisions will need to be properly safeguarded and made easily accessible to PRA staff to ensure that decisions are consistently applied.

We note that paragraph 2.77 of the White Paper states that the Government will consider further the arrangements for PRA engagement with practitioners during the consultation and pre-legislative scrutiny. We welcome the Government's commitment to ensure that the PRA will engage with practitioners and that such engagement is transparent. We look forward to commenting on the Government's proposals. However, at this stage we can see no policy reason as to why the PRA is not required to establish a practitioner panel and believe that its absence will significantly weaken the regulator. We can see a case for the scope of the FCA practitioner panel (new section 1I FSMA) encompassing common areas between the PRA and FCA but this would not cover solely prudential issues.

We note that the White Paper states at paragraph 2.78 that the Consumer Panel will not be retained and that the PRA will consult the FCA to take advantage of its expertise in consumer issues. The FCA will be required to maintain a Consumer Panel as the FSA currently does. It is clear that the PRA will be making decisions that will have implications for consumers and it is therefore vital that mechanisms are established to ensure adequate consultation between the PRA and the FCA in this context and specific reference should be made in the MoU.

We are disappointed to see in paragraph 2.106 that the Government is pushing forward with the proposed new powers concerning the publication of warning notices. This new power will be made available to both the PRA and the FCA and we have commented further on this in our response concerning the FCA. However, in relation to the PRA we find it strange that new section 391(6) FSMA gives the FCA the right not to publish a warning notice where such publication would be detrimental to the stability of the UK financial system but that this safeguard is not replicated in section 391(6A) covering the PRA. Whilst we note that one of the safeguards for the PRA concerns publication being detrimental to the safety and soundness of PRA authorised persons (therefore in line with the PRA's general objective) this does not mean the same thing and suggest that the safeguard is copied into the PRA's section.

Box 2.F: Consultation question

7 Do you have any views on the FCA's objectives – including its competition remit?

As noted in our previous submission, we support the formulation of clear statutory objectives and welcome the fact that the FCA's objectives are drafted as such and generally avoid the blandness of the PRA objectives that we have criticised above (see 2.D).

We think that, for the reasons given below, the proposed objectives need amendment to reflect:

- the FCA's role as the prudential regulator for the vast majority of authorised firms;
- the FCA's role as a markets regulator;
- that competition issues involve international as well as domestic considerations.

Given that the FCA will be the prudential regulator for the vast majority of authorised firms, it could be regarded as odd that it does not have an explicit operational objective reflecting that role. Pursuant to the June FSA paper, "The Financial Services Conduct Authority, Approach to Regulation", the integrity objective is concerned with the soundness and resilience of the trading infrastructure; the integrity of the financial markets, including the reliability of the price formation process and suitability of listing rules; combating market abuse; and addressing the extent to which the UK financial system may be used for the purposes of financial crime. These considerations do not address the FCA's responsibilities as the prudential regulator for a large number of regulated firms. We think that is an important aspect of the FCA's role, which seems to have been largely overlooked, and ought therefore to be reflected in an operational objective. As a general point, we note that there is still very little detail regarding the FCA's role as a prudential regulator, and the approach that it intends to adopt. This is a significant gap in the proposals to date.

Another critically important aspect of the FCA is its role as a markets regulator. Whilst, as noted above, we understand that the integrity objective encompasses some aspects of market infrastructure, as with the FCA's role as a prudential regulator, it appears that the FCA's role as a markets regulator has likewise suffered a lack of attention. It is essential that the FCA has a clear remit with respect to the regulation of markets, and that it has the appropriate resources to fulfil that function. We fear that, unless these roles are clearly addressed in legislation, the FCA will necessarily focus its resources, which are not infinite and need prioritisation, on other functions. There should be a differently focussed objective concerning the proper protection of the wholesale markets.

With respect to competition, we support the proposed approach whereby the FCA will have a duty to discharge its general functions in a way that promotes competition, insofar as this is compatible with its objectives. The competition aspects of the FCA appear to be domestically focused. Addressing the desirability of maintaining the competitive position of the United Kingdom in the international context is an argument for others to make. However we would have thought that it is important and, if the Government agrees, then the competition remit should extend to having regard to international considerations.

In this regard, we note that in its current form the Financial Services and Markets Act 2000 requires the FSA, in discharging its general functions, to have regard to a number of factors, including:

> "The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom".[1]

Whilst the international character of financial services and markets has been recognised in the various consultation documents, and reference has been made to the growing importance of European institutions and legislation, this does not appear to have been carried across to the proposed legislation. In discharging its functions the FCA should have regard to the wider European supervisory and regulatory framework, and its role within that.

Regulatory Principles

As stated in our previous response we do not consider that the principle in section 3B (1) (e) (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, we do not think it is a "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 to be helpful either as a guide to the FCA or as a means of holding it to account.

We also consider that the principle in section 3B (1) (f) (that regulators should exercise their functions as transparently as possible") should be qualified by the requirement that this is subject to observing principles of natural justice and fair treatment of authorised firms.

Consumer protection objective - Definition of consumer

As has been noted, the definition of "consumer" is very wide. Notwithstanding the requirement for the FCA to have regard to the differing degrees of experience and expertise that different consumers may have, the broad definition of "consumer" in this objective creates potential downstream problems, as it captures anyone, including market counterparties. The consumer protection objective is clearly aimed predominantly at retail clients acting outside the course of their normal business, but given the wide definition of "consumer", a proportionate approach is then put forward as a means to temper the application of this objective to such other clients who would not traditionally be regarded as a consumer.

We think it would be much better to have an objective more appropriately focussed on the target retail/non-professional client population with a separate objective concerning the regulation of markets and market professionals.

If the current approach and wide definition is retained then, because the definition of "consumer" is far broader than is commonly used in other contexts, including European legislation, care will need to be taken to ensure that the use of the narrow definition of the word "consumer" in other contexts, does not result in legislation or regulation that is designed for that narrow construction, being applied to the broader definition of "consumer" currently proposed under the new legislation.

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1 Financial Services and Markets Act 2000 s2(3)(e).

Further, we note that the proposed Act has at least four different definitions of "consumer".[2] This will almost inevitably cause great confusion. Accordingly, we suggest that a different term be used, for example "clients and counterparties" in the objective (which could include potential clients and counterparties).

Box 2.G: Consultation question

7 Do you have any views on the proactive regulatory approach of the FCA?

As the Government is aware we raised serious concerns on the issues covered in this section in our previous response. We are more than disappointed that there has been no material change to the proposals.

The product intervention power

We continue to have concerns regarding the nature and scope of the product intervention regime. There is very little detail regarding the nature of a "product", or how this will be defined. We think that identifying the objectionable characteristics of a product will be critical in order to provide appropriate certainty. Additionally, we have concerns about how the product intervention rules will work in practice, and the impact that intervention will have on consumers and providers. The proposals give rise to questions around legal uncertainty, for example how such powers will impact existing contracts and the role, responsibilities and liabilities of different firms within the distribution chain.

With respect to the temporary product intervention powers we note that the FCA will be required to consult on and publish a statement of policy setting out the circumstances in which it may make temporary product intervention rules, and we agree that this is appropriate.

We assume that the product intervention rules will not apply to products being sold into the United Kingdom by an EU entity on a cross border services basis, given that FCA rules will not be applicable in that scenario. This creates an unlevel playing field. We therefore encourage the Government to consider the product intervention rules in the light of the powers that the European Securities and Markets Authority will have to ban certain products. This would remove concerns about regulatory arbitrage. At the least, it would seem sensible to defer the implementation of any UK specific rules until the scope of the European regime is clear. Alternatively, such rules should not apply to any products that can be sold under European Directives on a cross-border basis.

Retail customer limitation

Paragraph 2.97 states that the product intervention tool is to be used "in support of retail customers." We can see no such limitation in the proposed legislative changes. Linking the power to the consumer protection objective does not achieve this as "consumer" within the meaning of that objective covers anyone of any kind anywhere. The provision that a further instrument is required for the power to be used to support the integrity objective does not

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2 Section 1C(3), section 425A, section 425B, section 404E.

mean that the existing power cannot be used in relation to professional and wholesale customers.

We think that it is extremely important that the restriction on the use of the power is clear on the face of the legislation if the Government really intends to limit the potential use of the power.

Statement of policy

We do not understand why the statement of policy is to relate only to the making of temporary product intervention rules. We did not understand the previous consultation to suggest this. These are new and significant powers, and we believe that the FCA should be required to have a stated policy as to its approach to the use of the power generally.

We commented previously on the proposal, now reflected in the draft, that the legislation make provision for the unenforceability of contracts made in breach of product intervention rules. The draft does not indicate what if anything is intended in respect of products that are sold in advance of a banning order? We assume that any rules could not have retrospective effect on contracts and indeed consider it highly undesirable that they should do so, but we suggest that this should be clearly stated in the legislation.

New financial promotion powers

We note that paragraph 2.103 says that there was widespread support for this power. As the Government is aware we did not support it and expressed concerns about it. We noted that 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, the FCA could 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 FSA financial promotions unit currently adopts a number of approaches in relation to financial promotions which it considers may breach its rules. This gives it flexibility. Is it intended that in future all financial promotion concerns will be dealt with by the "directions" route? We would hope not but this is not at all clear.

We do not think that a direction should require the authorised person to publish details of the direction (137P(2)(c)). This seems wholly inappropriate given that subsection (11) requires the FCA to do so.

However we also have serious concerns about this mandatory publication, *"the FCA must publish such information about the direction as it considers appropriate (even if the direction is revoked)"*. What if the FCA considers that that publication is not appropriate? We understand the process to involve the giving of a direction, which may or may not then be amended or revoked <u>after</u> representations have been made by the authorised person. It is wholly wrong to require publication of a direction which the FCA decides, after hearing representations, should be revoked. The fact that it is revoked strongly suggests that it should never have been made, let alone publicised. Paragraph 2.105 says that publication "may include a fair summary of the firm's representations where it contests the FCA's direction". Since publication is mandatory we believe that this should also be mandatory.

The entire process, even though it involves an asserted breach of regulatory rules, lacks the checks and balances that apply under the Warning Notice procedure and is to our mind fundamentally unfair and is not necessary to protect consumers from misleading promotions.

We also note that firms could avoid this outcome by establishing a presence in other Member States and advertising cross-border.

Early publication of disciplinary action

We continue to believe that this is one of the most objectionable parts of the new legislation. We simply do not accept that it contributes to the strategy of credible deterrence, and, if it does, it does so in a way which disregards fundamental legal principles and principles of natural justice, including the presumption of innocence, the right to know the case against you and to have an opportunity to present your case. The provisions dangerously shift the burden of proof towards a guilty until proven innocent stance. It is therefore a disproportionate means of achieving the stated objective. We cannot see how it helps consumers to be made aware of untested allegations.

As we noted before, 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. Not every warning notice results in a Decision Notice; very many do not. 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. In addition, in our experience, even when a warning notice is followed by a Decision Notice, the content is often materially different.

Paragraph 2.109 states that the power will be subject to safeguards. We do not think the safeguards listed in paragraph 2.110 are adequate. Prior consultation with the person to whom the notice is given cannot be adequate unless at the same time that person is given access to the material on which the FCA relies. How can he make a sensible comment on a potentially damaging publication without the opportunity to point out that the FCA has misdirected itself or is missing vital information?

This is not an academic point. At present such material is not disclosed until after the Warning Notice procedure has completed. In the real life experience of the members of this Committee in dealing with FSA enforcement actions, the provision of this material has often enabled a person to point out that it does not have the meaning etc. attributed by the FSA or that the FSA is missing other important information which would change the character of what it has. It is by no means the case that a person already knows the material which is in the FSA's hands. Allowing, in effect, a regulator to shout untested allegations through a megaphone is not in our view likely to bring respect for the regulatory regime.

In any event, the key nature of this issue is such that the safeguards framework and key substantive safeguards are matters that should be set in primary and secondary legislation, not by the regulator.

We do not agree with those who suggest this is no different to a criminal case. First and foremost, these are not criminal matters. Moreover it is wholly inappropriate to compare the giving of a warning notice with the formal charging of a defendant in a criminal justice process. The latter marks the start of a process which is wholly conducted before an

independent and impartial tribunal, and is largely conducted in the public domain with restrictions on what may properly be reported by the media. As a consequence there is always an independent person controlling the process, the testing of the prosecution's assertions is done in the public gaze and by evidence on oath, and the result clear for all to see. None of that is true of the warning notice step. The process is controlled by the regulator, the testing of the regulator's case is done in private and there is no provision for it to be by evidence on oath (the process is one of making representations not of assessing evidence). There is no process for exposing to public view any shortcomings in the regulator's case – and should the representations be wholly successful there is no proposed mechanism to explain why the published warning notice was ultimately not maintained. Simply withdrawing it from further public gaze does nothing to address media coverage that has already occurred and it will remain forever available on the internet.

As the Government is clearly determined on this course there are five fundamental changes which we believe must be made. These are:

(i) the provisions should not apply to individuals (unless authorised as sole traders) as here the balance of fairness must clearly lie in favour of the individual. In addition our understanding is that the concern is to protect consumers in their dealings with authorised firms;

(ii) firms must receive the material on which the FCA relies before they receive the Warning Notice;

(iii) as mentioned above, there should be a statutory framework for safeguards with certain specific safeguards or principles enshrined in legislation;

(iv) firms should have at least three business days' notice of publication of a warning notice, subject to a right of the FCA to override this in accordance with the statutory framework suggested above (giving reasons for doing so); and

(v) firms must be able to make such statements as they feel appropriate and in this regard new section 391 (1) (b) should be amended.

Box 2.H: Consultation question

8 What are your views on the proposal to allow nominated parties to refer to the FCA issues that may be causing mass detriment?

The current regulatory framework does not prevent individuals and/or organisations/industry bodies/consumer organisations, including the FOS from raising issues with the FSA regarding potential mass consumer detriment. We assume that this proposal is not intended to discourage individuals or organisations from continuing to raise issues with the FCA, therefore, the benefits of introducing a formal reference procedure are not immediately obvious or clear to us.

There is a risk, however, that the FCA may be required to prioritise formal referrals over other types of referrals, which may lead to the FCA inappropriately diverting resources away from responding to valid concerns raised by other sources or worse still diminishing its ability

to meet other regulatory priorities due to capacity and resources issues. Thus if the Government is minded to introduce a specific statutory provision, we suggest that:

- the formal rights of referral should be limited to a narrow range of bodies which have functions under FSMA;
- the basis of the formal referrals are clearly defined; and
- the steps, if any, the FCA is obliged to take realistically reflect the resources that are available, and its capacity to act within any proposed deadlines. We assume that the FCA would only be obliged to respond to issues that are important to its statutory objectives.

Box 2.H: Consultation question

9 What are your views on the proposal to require the FCA to set out its decision on whether a particular issue or product may be causing mass detriment and preferred course of action, and in the case of referrals from nominated parties, to do so within a set period of time?

The Government will need to ensure that any decision reached by the FCA does not:

- force it to prejudge either individual cases where it wishes to take disciplinary action or prevent it from acting properly in relation to such cases;
- prevent it from carrying out proper consultation on any proposed new rules or guidance;
- prevent it from taking account of evidence (for or against mass detriment) arising at a later date.

Given the complexity of the issues that the FCA may have to consider following a referral from a nominated party, we do not consider that it would be appropriate to impose any mandatory timescales for responses/decision. Further, the imposition of deadlines for responses will likely exacerbate the resource issues raised in our response to question 8 above. If the Government is minded to introduce "deadlines" for FCA responses then we suggest that the deadlines should take the form of a "guideline" rather than a mandatory requirement.

Box 2.I: Consultation question

10 Do you have any comments on the competition proposals for the FCA?

We note the proposals for a "two tier" approach to OFT intervention concerning anti-competitive situations in the markets supervised by the PRA and the FCA.

We consider that where the second tier is in issue, the backstop Treasury power of direction set out in section 140H should not only be subject to the Treasury having considered the

original section 140B advice from the OFT and the response of the relevant regulator to that section 140B advice, but also to the Treasury having consulted with, or at least provided an opportunity for additional representations to be made by, both the FPC and the PRA (and we suggest this should be regardless of whether the original section 140B advice was given to just one of those two regulatory authorities).

To give an example of why this should be the case: it may fairly be assumed that if the PRA or FCA has declined to take action in response to section 140B advice, it is because it regards the action recommended in that advice to be potentially harmful to its own regulatory objectives. It may be, for example, that a competition remedy which the PRA considered was at risk of impacting disproportionately negatively on, for example, the stability of certain firms in the deposit-taking sector could also have a relevant impact on confidence in the UK financial system in the view of the FCA (notwithstanding that the FCA was not the subject of the section 140B advice).

In such a case we agree it should be for the Treasury to balance the competing objectives of the competition authorities and the PRA/FCA, but in so doing it must be appropriate, and ultimately beneficial, for the Treasury to be required to take account of all relevant views of all relevant authorities in each such case.

Box 2.J: Consultation question

11 Do you have any views on the proposals for markets regulation by the FCA?

The FCA's power to suspend or limit the activities of a sponsor as provided for in section 88E (powers which are activated if the FCA considers that it is desirable to take action "to advance one or more of its operational objectives") assumes, when viewed alongside the power provided for in section 88A (which are activated if a sponsor contravenes a requirement or restriction), that the sponsor does not need to have breached any rule, requirement or restriction. Rather Section 88E appears to give the FCA a broad discretion to intervene in otherwise legitimate sponsor activity and the grounds on which it may do so are unhelpfully and unfairly opaque.

We regard the provision at new section 97A for requiring a skilled person report in respect of issuers as being wholly unwarranted. Issuers are not in the same relationship to the FSA as authorised investment businesses, whose whole business comes within the scope of regulation and whose ordinary business activities may need to be investigated. Issuers that seek a listing accept that they thereby become subject to a set of rules and obligations and must stand ready to be investigated if they fail to comply (and suffer the consequences if they are found wanting) but they should not, as a matter of principle, be subject to sanctions (which is what the obligation to pay for a skilled person's report amounts to) in the absence of, at the very least, a reasonable suspicion of wrongdoing. In addition to this objection of principle there is a serious risk that the UK will be perceived to be a less desirable place than other competing European financial centres as a place for listing. Moreover it is another provision which in practice is likely to operate more harshly on domestic firms as it is difficult to see how this power would be exercised in relation to an overseas issuer with no UK presence (the only remedy for non-cooperation may be to de-list); yet a differentiated approach in practice for UK and non-UK issuers seems undesirable.

Box 2.K: Consultation question

12 Do you have any comments on the governance, accountability and transparency arrangements proposed for the FCA?

We have particular concerns about the provisions for "regulatory failure" investigations (section 51 of the draft Financial Services Bill in case of the FCA, rather than section 46 as stated in paragraph 2.131 of the White Paper).

Our concerns relate to what the White Paper refers to as the "triggers" for the duty to investigate and report to arise. Some of the provisions are not sufficiently specific; other provisions risk creating 'hair triggers', likely giving rise to unintended practical administrative consequences.

Consumer detriment effect – a hair trigger?

Our concerns in relation to the consumer detriment trigger at section 51(1)(a)(i) of the draft Bill are equally relevant, albeit perhaps to a slightly lesser degree, to the financial integrity trigger at sub-paragraph (ii), and for the same reasons.

In view of the breadth of section 51, which applies not only to perceived shortcomings in the regulated community, but also to the detrimental activities of unregulated persons (such as boiler rooms and land-banking operators), the constituency of potential candidates for a mandatory investigation is substantial.

If one were to apply section 51 retrospectively to the events of recent financial history, there would likely be an enormous number of regulatory failure investigations generated by, for example:

- every instance of systemic mis-selling (which by implication identifies a failure to secure an appropriate degree of protection for consumers), and
- every significant rogue scheme operating beyond the FSA's regulatory perimeter,

because in each case it would be arguable that the FSA had failed to enforce its rules or Principles or had failed in its role as perimeter policeman.

It is to be questioned whether there should be an automatic duty to enquire and report in all such cases. There are two immediately obvious and adverse consequences:

- the FCA would risk being overwhelmed, and
- a regular stream of investigations and self-criticism would both lessen the impact of each report, and weaken confidence in the regulator and the UK financial system, and thus rapidly defeat the object of the provisions.

We also observe that it is not intended that the FCA deliver zero-failure supervision, thus implying that a certain degree of regulatory failure must be tolerated; does the Government intend to require the FCA to be required to explain itself in public each time there is a failure (other than insignificant failures)?

We consider that section 51 is thus at risk of being too rigid in its application, and that its scope is presently too wide and uncertain.

Regulatory failure in relation to the 'efficiency and choice' and 'competition' operational objectives

We query whether it is appropriate to tie regulatory failure triggers to either of these two objectives:

- judging an "adverse effect on the efficiency and choice in the market for....services" seems much too vague a process to found a mandatory duty. Further, it must be questionable that an "efficiency and choice" effect could ever be of the same order of magnitude (as regards the financial health of the UK or of individuals) to warrant the same mandatory procedure as a failure in respect of the consumer protection or integrity objectives. If this trigger provision is to be retained at all, we suggest it be recast as a power to investigate rather than a duty (probably subject to a Treasury backstop power of direction); and

- it seems wholly inappropriate for the trigger to be capable of being pulled by the FCA making a competition judgement when the Government has expressly decided not to give the FCA either fully or partially concurrent competition powers. If an adverse impact on competition is to be retained as a reporting trigger, an alternative option would be for the Treasury to pull that trigger after having received representations from the relevant competition authorities.

Engagement with regulators

We note the comments in paragraph 2.129 of the White Paper concerning FCA transparency and the decision not to legislate for the matters there mentioned which were canvassed for by some respondents to previous consultations.

We are concerned that the FCA may be implicitly encouraged by the Government to continue what is in our view an unfortunate tendency of the FSA to make or announce policy in non-official terms and circumstances (such as through speeches or in 'non-guidance' posted on the FSA website) but then nevertheless to hold firms and individuals to account as if formal rules or guidance had been made.

We suggest that the FCA should be scrupulous about following the proper procedures for developing and making known the standards it expects of firms and individuals. We hope that the Government will endorse this view.

Box 2.L: Consultation question

13 Do you have any comments on the general coordination arrangements for the PRA and FCA?

Operational delivery of effective coordination

We reiterate our comments made in response to February consultation, where we strongly urged the Government to consider a "shared services" function to act as a common back office for the PRA and the FCA in respect of regulatory processes. This is to minimise duplication on firms. We note that the Bank of England and the FSA will be publishing a document later this year setting out more fully the plans to deliver operational coordination, on which we expect to provide further comments. However, this is not enough. A shared services function and co-ordination of certain operations should be required; the Act should empower the Treasury to make orders on this.

We support the Government's proposal to impose on the regulators a statutory duty to coordinate, and in particular the inclusion of references to the need to use the resources of each regulator in the most efficient and economic way, and the principle that a burden or restriction which is imposed on a person or the carrying on of an activity should be proportionate to the benefits. However, the duty to coordinate provided for in new section 3D FSMA states that each regulator is required to consult the other regulator where the exercise of its function may result in "material adverse effect" of advancement by the other regulator of its objectives. Is this intended to denote a subjective or objective standard? More clarity over the circumstances in which regulators would be expected to coordinate on a day to day basis is required. This also seems to set the bar at which consultation is required at quite a high level (the requirement is only triggered when a potential material adverse effect to the advancement of the other regulator's objectives is perceived). We continue to have concerns that a lack of clarity and transparency over circumstances in which the duty to coordinate applies will leave the dual-regulated community in a position of uncertainty.

Memorandum of Understanding

Whilst we are of the view that the indicative list of issues to be included in the MOU between the FCA and PRA is reasonably comprehensive, we are concerned that because there is no requirement to publish in the MOU any "technical or operational matter not affecting the public", this will give the authorities licence not to include much of the operational detail that is of interest to dual-regulated firms, if not to the public at large. We are not therefore convinced that the regulators should be given the ability under section 3E(8)(b) to omit from the memorandum material relating to aspects of compliance with their co-ordination duty where such aspect "is a technical or operational matter not affecting the public". The regulators would have the ability under section 3E(8)(a) to omit information which they consider not to be in the public interest. Any other information should be addressed in the memorandum. Section 3E(1) provides that the information must relate to the performance by the regulators of their qualifying functions. Accordingly, the presumption should be that material relating to these functions should be included in the memorandum or, if not appropriate to include in the memorandum, published in some other manner. Further, we struggle to identify those aspects of the co-ordination by the regulators of the performance of their qualifying functions which do not affect the public. The grounds on which exceptions to transparent conduct by the regulators are made should be strictly limited, for example where the co-ordination or performance relates to a particular person or case.

It is not clear why the regulators are permitted but not required to include in the memorandum provided for in section 3E of the Draft Bill, material on the subjects listed in section 3E(2). The regulators are required to include material on the subjects listed in section 3E(3) and we can see no good reason why that same obligation should not also include the subjects in section 3E(2). The regulators would still be entitled by section 3E(8) to omit material on public interest grounds in respect of the subjects in section 3E(2).

We support the requirement in FSMA that the PRA and FCA include in their annual reports an account of how they co-ordinated throughout the year, but Treasury should have the power to impose minimum requirements in case such accounts are too bland.

Is the PRA's power to veto the FCA's proposed use of any of its powers limited and transparent enough as to the circumstances in which it could be used? We support the requirement for the PRA to consult the FCA before exercising its right of veto. Although PRA is required to give a copy of the notice to Treasury, which in turn must lay it before Parliament, there is no indication as to whether this must be done before or after the power has been exercised. This should be clarified. The circumstances in which the PRA may exercise its power is still vague in the draft legislation – e.g. it is exercisable where the use of the FCA's power may (a) threaten financial stability or (b) result in the failure of a PRA-authorised firm in a way that would adversely affect the UK financial system. Market participants still therefore lack a clear picture of circumstances in which the veto can and is likely to be exercised. There is clearly scope for disagreement between the PRA and the FCA over the exercise of the veto, and the legislation adds to the perception of the PRA as the more senior regulator.

Paragraph 2.149 indicates that the PRA's right of veto under section 3H of the Draft Bill could not be used "to prevent the FCA from doing something that it is legally required to do". However, section 3H(7) refers only to EU and other international obligations. Accordingly, it is likely that the correct interpretation of section 3H is that the veto could be used to prevent the FCA from performing a legal obligation which is not an EU or international obligation. If the intention is as stated in paragraph 2.149, the text in section 3H(7) would require amendment. If enacted in its current form, the veto right in section 3H is likely to permit the PRA to exercise its veto with the result that the FCA may find itself in breach of an obligation under domestic legislation. If this is the intention, the guidance in paragraph 2.149 should be corrected.

Box 2.M: Consultation question

14 Do you have any views on the detail of specific regulatory processes involving the PRA and FCA?

Authorisation

We support the Government's decision in opting for the "alternative" authorisation process whereby for dual regulated firms the PRA as the authority with responsibility for prudential regulation of an applicant, will manage the application process overall, and will grant permission (although the FCA's consent will be required). However, we remain of the view that the FCA is the appropriate regulator to lead on applications for dual-regulated firms, since this would facilitate the development of a centre of authorisation excellence within a single regulator.

Alternatively, this is a process well suited for the shared services function for which we and others have pressed (see our response to 2.L).

The Government, in the case of dual-regulated firms, still intends to give the authorities powers to designate sole or lead jurisdiction under the threshold conditions, yet the process provided for in the draft legislation is unclear as to specifically how designation will take

place, and what would happen if the authorities cannot agree. It is crucial for market participants to understand how these arrangements will work, and further clarity is required.

We reiterate our comments concerning the need for firms to be given clear expectations of the time limits for processing authorisation applications and the service standards that will be applied. It is important that the time taken to review an application does not exceed the current statutory time limits and service standards applicable to the FSA. 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.

Box 2.N: Consultation question

15 Do you have any comments on the proposals for the FSCS and FOS?

We welcome the recognition in the White Paper that EU developments on compensation schemes may have a considerable impact on this aspect of regulation. We agree that, pending those developments, the existing approach on the UK's compensation scheme (which has been the subject of recent review itself) should be retained.

In relation to the position of the FOS, we consider that the White Paper still misses a key point. As we pointed out in our April response to the previous consultation, the FOS' dispute resolution mechanism should not mean a process with unpredictable outcomes, or outcomes that have no sound basis. In practice the FOS has taken on the character of a secondary regulator, whose awards take on an unwarranted role as precedent, and are used to justify the imposition of a retrospective review and compensation process across a significant part of a firm's business. This can result in retrospective imposition of different standards from those understood at the time of the original business – something the FCA would not properly be permitted to do using its powers. The FOS' role should be constrained so that it has no power to make an award when a firm has acted in compliance with the applicable regulatory and legal obligations. As a result we consider that the FOS should be obliged to apply the law in all cases. "Swift and impartial" should not mean "irrespective of legal obligation".

The transparency proposals in the draft legislation further emphasise the need for the FOS' decision making to be constrained in this way. Publication of awards will increase further the likelihood that they will (in the eyes of the FOS and consumers – and potentially the FCA) raise expectations that they are to be followed.

In our April response, we expressed concern about the FOS having a completely free discretion on publication of decisions. We do not consider that the publication proposals in the draft legislation are an improvement in ensuring fairness to firms about which complaints are made. It is difficult to see any fairness in a process that contemplates that the person initiating a complaint can insist on anonymity (irrespective of the merits of his complaint) whereas a person with no option but to cooperate in the process, and no certainty that the contemporaneous regulatory requirements will be used as the standard for assessing the merits, cannot do so. Indeed on the face of the proposed legislation, a person who makes a completely unfounded complaint (and who is someone who might in other contexts be regarded as vexatious) can insist on anonymity, yet a firm subjected to what is ultimately

found to be a frivolous complaint must be named. In addition, naming a firm as having breached a regulatory obligation in a FOS award is the same, in kind, as a public censure against the firm. If such a censure was to be imposed by the FCA or the PRA, there would be far greater safeguards of fair hearing than exist for the FOS. This highlights a theme which appears more than once in the draft and in Government policy, namely mechanisms are being introduced which completely undermine the protection offered by other parts of the Act which were designed to ensure fair process.

The FOS currently publishes summaries of example awards (both upheld and not) in its "Ombudsman News". These are summaries of the issues, approach and outcomes on an anonymised basis intended to assist firms and other users of the FOS. If there is merit in publishing FOS award outcomes to a greater extent than at present, to assist users of the FOS, there seems to us to be no justification in going further than the approach currently taken (i.e. anonymised and summary).

Variation and removal of permissions

We support the Government's proposals regarding the requirements for the PRA and FCA to consult with each other prior to exercising OIVoP powers in a way that could affect each other, and for the statutory MOU to set out further information about the use of OIVoP.

Approved persons

We support the Government's alternative proposal regarding the approved persons regime whereby the PRA would have primary responsibility for designating SIFs, but where the FCA may designate SIFs where the PRA has not done so. The authorities would be required to consult each other to minimise the risk that the codes they make overlap or duplicate.

However, we are still of the view that this "twin track" application process is potentially cumbersome, and duplicative, and a system where one regulator had overall responsibility for the whole application would be more sensible. Considerable co-operation between the FCA and the PRA will be required on how the approved persons regime will operate in practice, including which of the controlled functions concern the FCA and the PRA. In particular, we reiterate our comments made in relation to the previous consultation regarding the necessity of ensuring that timeframes for processing approved persons applications do not increase, and that applicants for SIF functions which concern both the PRA and the FCA and require an interview are subject to only one interview attended by representatives from both authorities.

Passporting

We reiterate our concerns with the proposed process for outward passporting firms, whereby the process for dual-regulated firms wishing to establish branches in other EEA Member States under a passport is that the PRA is responsible for issues relating to financial soundness, and the FCA is responsible for all conduct issues. In particular, we are concerned that there is to be no discussion concerning how this separation of responsibility would occur in practice.

We have some concerns with the Government's proposals regarding the PRA receiving notifications from overseas regulators concerning some EU directives, with notifications in respect of other directives going to the FCA. Whilst we understand this will be provided for in

secondary legislation, there will need to be a clear framework within the secondary legislation for communication between the FCA and the PRA of notices received.

Rule making

We reiterate our concerns about the potential implications of the division of the FSA current integrated FSA Handbook, and whilst we support the Government's proposals requiring the regulators to consult with one another before making rules, we remain of the view that two sets of rules covering the same content is at the very least unnecessary and burdensome to firms who need to analyse their obligations under both sets of rules. This seems unnecessary considering the increasing amount of regulation coming out of Europe, and the fact that much of this regulation now takes the form of Regulation, which has direct effect in Member States and does not need to be implemented via domestic legislation. We would also urge that the regulators' duty to consult one another before making rules applying to the same functions should also apply to any guidance (whether formal or informal), or statements of purpose (in the case of the PRA) relating to these rules.

Group supervision

We welcome the Government's proposals that it will expect coordination and cooperation between the two authorities as the main means of achieving effective and efficient group supervision, and we look forward to seeing the draft MOU between the PRA and the FCA.

Unregulated holding companies

We welcome the safeguards that the Government is proposing to place on the proposed power of direction over unregulated parent undertakings which control and exert influence over authorised firms. In particular, we welcome the statement by the Government that the power should only be used by the regulators on "relatively rare occasions" and that the trigger for the use of the power has been set at a higher level than proposed in the February consultation (e.g. where the regulator considers that the acts of the parent undertaking are having a material adverse effect on the regulation of authorised persons in pursuance of its objectives).

We support the proposal by the Government that before exercising the power of direction, the regulator must consider the effectiveness of its powers in relation to any of the authorised persons in the group, not solely the direct subsidiaries of the 'target' parent. We think it is important that the power is exercisable only when all other available regulatory tools have been exhausted in relation to the relevant authorised firms and that this is clear on the face of the legislation.

Change of control

We reiterate our comments made in relation to the proposals in the February consultation that we are of the view that it is desirable for all change of control applications to go to a single regulator, and we remain concerned by the proposals to require applications for change of control involving a group that includes dual-regulated firms and firms that are prudentially regulated on a solo basis by the FCA to be submitted to both the FCA and the PRA.

This debate (and the issues arising under other heads, particularly in respect of variations of permission, approved persons, and passporting as addressed under the headings above in

this response to 2.N) again emphasises the need for a shared services function or single approach to be presented on a range of process issues.

Registers

Another area where a shared service should be required is the maintenance of a single register of authorised persons, approved persons, recognised bodies, etc. (all accessible through one internet address as at present), rather than leaving this issue to the regulators to agree.

Part VII transfers

We reiterate our comments made in relation to the proposals in the February consultation, and in particular that we doubt the sense of the PRA leading on all Part VII transfers, particularly a Part VII transfer of life business involving with-profits business, where matters relating to Treating Customers Fairly are key, including in communications to policyholders.

If you wish to discuss our comments, you may contact me on +44 (0)20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully

pp.

Margaret Chamberlain
Chair, CLLS Regulatory Law Committee

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