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CLLS Regulatory Law Committee response to H.M. Treasury consultation: "A new approach to financial regulation: draft secondary legislation"

The City of London Law Society represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

This response to the HM Treasury (the "**Treasury**") consultation: "A new approach to financial regulation: draft secondary legislation" (the "**Consultation**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets and in particular advise a wide range of credit intermediaries, investment managers, custodians, private equity, debt and other specialist fund managers.

We welcome the Treasury's decision to consult on the content of the secondary legislation and the opportunity to respond to the Consultation. We have not responded to specific questions raised in the Consultation because, in the main, those questions relate to matters which do not concern us as lawyers and which are likely, in any event, to be addressed in other responses from investment firms and trade organisations. However, we are pleased to have this opportunity to comment on certain aspects of the guidelines that cause us concern or which we consider could be improved significantly from a legal perspective.

The Financial Services & Markets Act 2000 (PRA-regulated Activities Order) 201*

This Order is made under section 22A of the Financial Services and Markets Act 2000 which empowers the Treasury to specify the regulated activities that are PRA-regulated activities.

Consistently with the declared focus of the PRA being banks and insurers (see the PRA's Approach to Supervision documents of October 2012), the specified regulated activities include accepting deposits and effecting and carrying out contracts of insurance and certain activities associated with Lloyd's (Art 2 (a) to (c) and (e) to (g)).

A further regulated activity is dealing in instruments as principal when carried on by a person designated by the PRA (Art 2 (d)). The PRA is empowered to designate such a person where two conditions are fulfilled (1 and 2) and a discretionary power (3) is exercised (Art 3 (1)). These are, in turn:

1. The firm holds permission to deal in investments as principal (or the EEA equivalent);

2. The firm is a BIPRU 730k firm (or non-EEA equivalent);

3. The discretionary power is for the PRA to designate a firm where it considers it desirable that its dealing as principal should be regulated by the PRA having regard to two elements, being:

    i. The PRA's objectives; and

    ii. The assets of the firm and of members of its group that also fulfil the two conditions; to whether another group member has been designated under this power; and to whether the firm's activities might materially impact the PRA's ability to advance its objectives with regard to the group's PRA-regulated firms.

We acknowledge the safeguards provided in Art 4 relating to the provision of reasons and the right for a firm to make representations and refer the matter to the Tribunal, and in Art 8 requiring the PRA to consult on and prepare a statement of policy in relation to its exercise of discretion.

We nonetheless have three reservations in relation to this power:

1. The PRA's power to effect an immediate designation (Art 4 (2)) would presumably have the effect of suspending a firm's ability to conduct dealing as principal activities. The trigger for exercise of this immediate power is solely "*if the PRA considers it necessary*" (Art 4 (3)). In light of the serious consequences of the immediate exercise of this power we consider that immediate designation should only be exercised where the PRA considers that there is an imminent threat to the effective discharge of its objectives that cannot otherwise be prevented.

2. We further consider that the PRA's designation of firm should not (otherwise than in the case of an immediate designation) take effect before such date that, in the normal course, a firm might reasonably be expected to meet the PRA's requirements for granting this permission.

3. We are concerned that the PRA's criteria are substantially subjective so that, depending on the quality of the promised statement of policy, it may prove difficult to advise a firm with any degree of certainty whether the activity of dealing as principal will or will not require authorisation by the PRA. This creates the barrier to entry of uncertainty, especially if the PRA retains the power of immediate and almost discretionary designation. We therefore note the need for the PRA to produce clear and explicit guidance in its statement of policy.

Threshold Conditions

As a general matter, the overall effect of the proposed new content of the Threshold Conditions (TC) could enable the PRA and/or the FCA (as the case may be) to escalate any non-trivial alleged regulatory failing (including matters involving a high

degree of subjective judgment) into a TC issue, raising stakes for firms and giving rise to a degree of legal uncertainty.

In the context of the "effective supervision" TC, it is not entirely clear what the term "effective supervision" means. This gives rise to a risk that one of the relevant regulatory authorities considers a firm not to meet the effective supervision threshold condition as a result of the relevant authority's, and not the firm's, own failings due to a lack of quality or sufficiency of resources. This risk could be mitigated by expressly stipulating that that effective supervision means "*effective supervision by a reasonable and adequately resourced regulator*"?

We consider that the "Suitability" TC, and in particular the "manner of compliance" sub-TC is potentially very onerous. For example, as currently drafted, a robust but reasonable challenge to a regulator's case could be deemed a TC failing. As the Threshold Conditions already include an "open and co-operative" dealings requirement, we consider it disproportionate to include the "manner of compliance" concept in this context. If the Treasury considers it necessary to include this sub-TC, then it should expressly be tied the "open and cooperative" concept.

The requirement for a firm's management to act with "probity" in the "suitability" sub-TCs also gives rise to an increased risk of uncertainty. This is because the "probity" adjective, in this context, is a very subjective concept. We suggest that the concept should be qualified by reference to the judgment of a reasonable consumer (or consumers) of the firm's services. An example of another context in which such a concept has been relied upon is the reasonable investor test in the context of market abuse.

If the Treasury would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

p.p.

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