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Tunde Koleoso
Policy Co-ordination Team
Prudential Regulation Authority
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24 March 2014

By email to: tunde.koleoso@bankofengland.co.uk

Dear Mr. Koleoso,

Re: Prudential Regulation Authority Consultation Paper on the PRA Rulebook (CP2/14)

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. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of the PRA's consultation paper on the PRA Rulebook (CP2/14) (the "**Consultation Paper**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**").

The Committee welcomes the opportunity to provide comments on the proposed PRA Rulebook, but has limited the scope of this response to its views on the proposed PRA Fundamental Rules ("**FRs**") as set out in section 3 of the Consultation Paper, which, due to their pervasive nature in the context of firms' operations, it considers are of particular importance. In addition, the Committee has included a further important observation on the proposed drafting of rules reflecting the PRA's information gathering powers, which it has identified as being relevant to the statutory protection for certain communications between legal advisers and their clients contained in the Financial Services and Markets Act 2000 ("**FSMA**").

As a general observation, the Committee considers that the proposed changes to the Principles for Businesses (the "**Principles**"), which the PRA inherited from the FSA, are unnecessary and risk causing significant legal confusion amongst dual-regulated firms. It would be preferable if such firms continued to be subject only to the current Principles, applied by both the FCA and the PRA, in order to ensure that there is sufficient consistency between the regulatory requirements of the two regimes to which they are subject.

The Committee is concerned that the introduction of the FRs risks creating legal uncertainty and potential unforeseen conflicts between the obligations that they will impose and those that will apply by virtue of the continuing application of the Principles. If the overarching high-level requirements to which firms are subject are to be modified, the Committee's view is that it would be better to implement this by amending the Principles, but nonetheless maintaining the single set of rules.

The Committee recognises that there may be differences between firms which are regulated only by the FCA and those which are subject to dual regulation. However, to the extent that such differences require the Principles to be applied in a modified manner as between those two types of firm, it would be possible to reflect this through guidance issued by the PRA, following discussion with the FCA. The risk of the current proposed approach is that dual-regulated firms may find themselves in the highly undesirable position of having to navigate conflicting requirements caused by a variation in wording between the respective standards. Even if the wording is not directly inconsistent, it is probable that the confusion that is likely to result from parallel but alternatively worded provisions will outweigh any potential benefit that might be obtained from bespoke PRA provisions.

COMMENTS ON INDIVIDUAL PROPOSED FUNDAMENTAL RULES

FR1 – A firm must act with integrity

1. The Committee notes that this proposed FR has replaced the requirement that a firm "*conduct its business*" with integrity in Principle 1 with the requirement that the firm "*act*" with integrity, but does not consider that this amendment has any substantive effect.

2. The Consultation Paper clarifies the scope of the application of this rule at paragraph 3.14, stating that a firm "*must show adherence to this standard in the everyday course of its business and when making business-related decisions*". The Committee considers that this is, in effect, simply another way of stating that this requirement applies when a firm is conducting its business. The amended wording risks creating confusion amongst dual-regulated firms about how this fundamental obligation applies in each case, which would be particularly unfortunate given the central importance of the requirement for integrity.

3. If the PRA does not agree with the Committee's general views above about the desirability of a single set of rules and decides to implement the proposed FRs, the Committee would strongly recommend that the existing wording in Principle 1 be reproduced verbatim in FR1.

FR2 – A firm must act with due skill, care and diligence

4. The Committee's comments in relation to FR1 above are equally applicable to the proposed drafting of FR2. Accordingly, the Committee recommends that, if the FRs are adopted, the current wording of Principle 2 should be reproduced exactly in FR2.

FR3 – A firm must act in a prudent manner

5. In the opinion of the Committee, to the extent that the proposed FRs introduce any new requirements, this can only be justifiable if the current Principles do not already provide adequate standards in the circumstances in which the new rule would apply. Although the drafting of FR3 is generic, the requirement it imposes appears to be adequately encapsulated in the current Principle 2, requiring that the firm conduct its business with due care, skill and diligence, and Principle 4, which relates to the requirement for financial prudence. It is difficult to see what other additional standard a firm can be expected to observe by virtue of the use of the term "*prudence*". The PRA's observations in paragraphs 3.17 and 3.18 that this would oblige a firm to "*demonstrate sound judgement and exercise caution*" and that the term connotes "*foresight, circumspection and caution*" would appear to be restatements of the meaning of the words "*care*" and "*diligence*" in Principle 2. It is unclear whether the proposed wording is intended to imply that a firm could act in an imprudent manner and simultaneously still be exercising due care. The Committee does not consider that any further benefit can be obtained by overlaying another rule with the same substantive content.

6. In contrast, the imposition of the new requirement in FR3 has the potential to result in wide-ranging uncertainty because of its imprecise wording. The ambit of the obligation as drafted is potentially very broad and the wording provides no guidance on how firms should assess whether they are in compliance with the rule. The PRA's assertion in paragraph 3.18 of the Consultation Paper that it considers that prudence is "*a term that firms should be able to understand*" may be questionable, given that the traditional definition of the term "*prudence*" is likely to mirror the requirements of Principles 2 and 4, as discussed above. If the obligations imposed by FR3 are intended to extend beyond what is envisaged in those principles, the meaning of the term is not immediately clear and firms are unlikely to be better placed than anybody else to speculate on possible interpretations. The Committee considers that professional advisers would find it difficult to explain the distinction between these concepts and to give practical advice to clients about their compliance obligations in this regard. The Committee is also concerned that the vague nature of the potential obligations under FR3 risks firms being subject to enforcement actions based on the benefit of a hindsight construction of the term.

7. Moreover, there would be an inevitable implication, which again professional advisers would find difficult to refute through a rational analysis of the relevant standards, that a dual-regulated firm is not held to a standard of prudence insofar as conduct matters are concerned.

8. If the intention of FR3 is to reduce or restrict the possibility of a dual-regulated firm engaging in a hostile takeover or other potentially destabilising mergers, acquisitions or corporate reorganisations, the Committee considers that while the current wording may have that effect (depending on the precise meaning attached to the phrase "*prudent manner*"), it would also be likely to generate a range of other unintended negative

consequences and it would be preferable to deal with any particular concern through guidance.

9. For the reasons outlined above, if the FRs are implemented, the Committee would recommend that FR3 be deleted entirely to avoid undesirable duplication and uncertainty.

FR4 – A firm must at all times maintain adequate financial resources

10. The Committee considers that the insertion of the phrase "*at all times*" into the current Principle 4 is otiose because the word "*maintain*" currently connotes the necessary element of continuity. Again, any such difference between FR4 and Principle 4 implies a substantive difference which, we believe, cannot be intended by the PRA or the FCA. The Committee therefore considers that the wording in FR4 should mirror the existing wording in Principle 4 precisely.

FR5 – A firm must have in place sound and effective risk strategies and risk management systems

11. In principle, the Committee does not object to the division of the two elements of the current Principle 3 into separate requirements in FR5 and FR6. However, the Committee is concerned that the standard of "sound and effective" risk management systems imposed by the proposed wording of FR5 is considerably higher than the equivalent requirement in Principle 3, resulting in a significant disparity between the duties of the firm in respect of each.

12. This mismatch in the obligations imposed by the FR and the Principle may lead to significant practical difficulties when firms seek to apply the requirements in the context of their everyday operations. For example, in paragraph 3.23 of the Consultation Paper, the PRA notes that the requirement for sound and effective risk management systems extends beyond those applying to a firm's financial stability, but also includes "*risks material to a firm's activities including, for example, legal and strategic risk*". Since risks of that nature are also likely to be relevant to the firm's conduct as regulated by the FCA, a dual-regulated firm would find itself simultaneously subject to the requirement for "adequate" risk management systems and "sound and effective" risk management systems. This has the potential to cause severe confusion, with two different legal standards applying to the firm's internal affairs.

13. The Committee notes the PRA's concerns in paragraph 3.21 of the Consultation Paper in relation to risk management prior to the financial crisis, but does not consider that subjecting firms to two inconsistent rules is likely to address this issue effectively. It is not immediately clear that the deficiencies of risk management systems prior to the financial crisis, as identified by the PRA, would not already have been caught under Principle 3; to the extent that such systems had obvious shortcomings, it is likely that they were in any case inadequate. The Committee would therefore suggest that the PRA issue guidance which emphasises the importance of risk management systems and which states that "adequate risk management" systems are a bare minimum and that sound and effective systems would be desirable.

14. The Committee is also concerned that the use of the term "*must have in place*" in FR3 rather than "*must take reasonable care to organise*" imposes a significantly higher standard than that currently imposed under Principle 3. In particular, it could be interpreted as imposing strict liability upon those firms whose risk management systems or risk strategies inadvertently turn out to have been ineffective in a particular instance despite the firm taking reasonable care when implementing them (for example, due to a remote and highly unusual risk materialising). Such a result would clearly be inappropriate, as no firm is able to guarantee that its risk management systems are completely sound and effective. Risk by its very nature is typically impossible to eliminate altogether and requires a proportionate response.

15. The Committee would suggest that, at a minimum, FR5 should therefore be redrafted in terms that a firm must "take reasonable care" to put in place sound and effective risk management systems.

FR6 – A firm must organise and control its affairs responsibly and effectively

16. The Committee's comments in relation to the use of the term "*must*" in FR5 above are equally applicable to FR6, which has been derived from the second half of the current Principle 3.

17. The Committee is concerned that if FR6 is implemented as currently drafted, this should not lead to identical requirements being imposed on individuals within the senior management of firms as part of the implementation of the PRA's Senior Management Regime. It would be inappropriate for individuals to be subject to an obligation requiring them to do anything other than take reasonable steps in connection with the organisation and control of the firm.

18. As with FR5 above, the Committee would therefore propose that FR6 be redrafted so as to require a firm to take reasonable steps to organise and control its affairs responsibly and effectively.

FR7 – A firm must deal with its regulators in an open, co-operative and timely way and must appropriately disclose to the PRA anything relating to the firm of which the PRA would reasonably expect notice

19. The Committee notes that the requirement for "*timely*" disclosure has been added in FR7 and does not exist in the current Principle 11. If this requirement is to be applied explicitly, the Committee considers that it should be applied to both firms which are regulated only by the FCA and dual-regulated firms in order to ensure consistency. The current variation in wording may create the unfortunate implication that firms are not required to make timely disclosure of relevant information when dealing with the FCA.

20. The Committee notes that the FCA has issued guidance with respect to the the requirement of timeliness under the current Principle 11 (for example, in SUP 11.4.8G, which refers to the requirement to disclose information "*at the earliest opportunity*"). The Committee considers that the PRA should adopt the same approach and issue its own guidance to firms about when disclosure should occur if it considers that this is necessary.

21. Accordingly, if Principle 11 cannot be amended to refer to timely disclosure, the Committee would suggest that FR7 should be revised so as to conform with the wording of the existing Principle and that the PRA should issue connected guidance instead.

FR8 – A firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services

22. The Committee acknowledges that resolution planning for PRA-regulated firms is of particular importance and therefore understands the need for firms to be subject to this requirement. However, the Committee does not understand why this obligation has been elevated to the status of a Fundamental Rule, when the purpose of such rules is to provide general guidance on pervasive duties and behaviours relevant across the full range of a firm's operations.

23. Resolution planning is a much more specific concept that is most logically and appropriately dealt with in more granular provisions accompanied by detailed additional guidance. At present FR8 stands noticeably apart from the other Fundamental Rules in that it mandates a specific action to be taken rather than prescribing standards of behaviour that a firm should follow in the performance of its regulatory duties.

24. The Committee would therefore propose that this Fundamental Rule be deleted in its entirety and be relocated to a more appropriate part of the PRA Handbook (for example, as a new section in SYSC applying to dual-regulated firms).

FR9 – A firm must not knowingly or recklessly give the PRA information that is false or misleading in a material particular

25. The Committee considers that it is inappropriate to restate the elements of the criminal offence in section 398 FSMA in a body of Fundamental Rules, particularly because, as the PRA acknowledges in paragraph 3.35 of the Consultation Paper, the obligation as envisaged in FR9 extends beyond the ambit of the statutory provision. The similarity of the wording used in this rule with the statutory wording has the potential to confuse firms about the scope of the criminal regime, which is plainly undesirable.

26. To the extent that a firm knowingly or recklessly provides false or misleading information and the PRA is unable or unwilling to take action under section 398 FSMA, such a situation must surely already fall within Principle 11, FR 7, Principle 1 and/or FR1. As a result, it is unclear why the PRA considers that the specific addition of FR9 is necessary.

27. The Committee would therefore suggest that FR9 should be removed in its entirety. If the PRA considers that it is necessary to clarify that firms must not give misleading information to the PRA, about which the Committee is doubtful, this could be achieved by issuing guidance in relation to FR1.

COMMENTS ON PROPOSED PRA RULEBOOK INFORMATION GATHERING INSTRUMENT 2014 ANNEX B: INFORMATION GATHERING – RULE 4.1

28. The drafting of Rule 4 on access to documents and personnel appears to suggest that although a firm is entitled to rely on section 413 of FSMA in not providing access to documents requested by PRA (Rule 4.1(1)), the protection is not available under Rule 4.1(4) in respect of responses to PRA questions.

29. Section 413 FSMA, which – despite being headed "Limitation on powers to require documents" - expressly states that a firm cannot be required under FSMA to disclose a protected communication (and then refers to a "communication" as distinct from an "item" in s.413(3) and (4)). The current drafting of the proposed Rule 4.1 has the apparent effect that it would be open to the PRA to circumvent the statutory protection which Rule 4.1(1) acknowledges exists in respect of a written opinion by using Rule 4.1(4) to ask the firm about the content of the legal advice it has received, rather than requesting the actual written document containing that advice.

30. Consequently, the Committee proposes that Rule 4.1 be recast to read: "*Subject to section 413 of FSMA, a firm must, in relation to the discharge of the PRA's functions under any relevant legislation:*". This would ensure that all of the following sub-clauses are subject to s.413 FSMA.

If you 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.

Yours sincerely,

Margaret Ch

Margaret Chamberlain

Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

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