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Future Regulatory Framework Review
Financial Services Strategy
HM Treasury
1 Horse Guards Road
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By email: FRF.Review@hmtreasury.gov.uk

18 February 2021

Dear Sir or Madam

HMT Financial Services Future Regulatory Framework Regulatory Framework Review Phase II Consultation (the "Consultation")

The City of London Law Society ("**CLLS**") represents approximately 17,000 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 letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Being made up of legal practitioners in the financial services sector, the Committee recognises that the UK's departure from the EU creates both the need to make certain changes to the UK's financial services regime but also a wider opportunity to re-design it in a way that works for the UK and its future ambitions for the sector. The Committee is therefore pleased to respond to this Consultation given its importance to the future of the UK's financial services regulatory regime.

1 How do you view the operation of the FSMA model over the last 20 years? Do you agree that the model works well and provides a reliable approach which can be adapted to the UK's position outside of the EU?

We think the FSMA model has worked well. The structure has accommodated some major amendments including the creation of new regulators and introduction of new regulatory regimes, alongside an ongoing list of smaller amendments. It makes it easier to read and understand the legislation when it is published in consolidated form at various junctures and it would be helpful to incorporate amendments that have not been made as part of FSMA, but the underlying structure is sound.

There are some aspects of the FSMA structure that we think make it very practical:

- It ensures that the source of most financial services requirements is in one place, which makes it easier to find the underlying legislative power.

- FSMA generally indicates where a provision might be further developed in secondary legislation or regulatory rules.

- Non-legal practitioners can focus on the regulators' rules but the rules usually point to the law as appropriate.

On the first point, there are different views on whether regimes that are contained in other pieces of legislation, such as the payment services regulation, should be merged into FSMA, and there may still be reasons to maintain separate legislation for specialist regimes whose participants have little need to consult other parts of FSMA. In addition, FSMA has become very broad in scope and without rationalisation and a continuing determination to reserve detailed provisions for secondary legislation, it could get unwieldy. Further, adapting it to the post-EU era will not be straightforward and will likely require significant amendment anyway, even with the work already undertaken during the onshoring process, so if there were a desire to do something more radical, now would seem like a good opportunity.

The financial services sector has become very used to European financial services legislation and many practitioners probably feel more familiar with the European process, style and content of legislation than that of the UK. While we would not advocate the adoption of a model that mirrors that of the EU, there are a few aspects that we think are worth borrowing for the new UK regime. These include:

- Making it clearer on the face of the legislation what its objectives are.

- Some degree of sectoral organisation so that firms and unregulated persons performing different roles can more easily locate the legislation that applies to them without having to worry about provisions that are not relevant.

- Including review periods in the legislation.

We note that some of these advantages might support some of the ideas set out in the Consultation.

We also note the government's proposal to set out in legislation the overall purpose and regulatory approach for specific areas of financial services legislation and the example of prudential regulation of insurance that is provided. While we see the merit in this approach, we note that the government does not explain how it proposes to differentiate and define different areas. We think this could be done in several ways, including by reference to activities or more functional roles. However, whichever route is chosen, we would not underestimate the likely complexity of trying to create such a categorisation and we think it will be important to accept that there will likely be some overlap and duplication in the result. It would be unfortunate if this were to add complexity to the new regime, which needs simplification more than anything else. Please also see our comments on the sectoral approach in answer to Question 5.

2 What is your view of the proposed post-EU framework blueprint for adapting the FSMA model? In particular:

What are your views on the proposed division of responsibilities between Parliament, HM Treasury and the financial services regulators?

We agree that Parliament and HM Treasury should set the overall policy direction and financial services regulators should work on the detailed rules given where the expertise/time for the relevant roles is.

However, we would suggest that:

- With the removal of the EU element of the current system (i.e. legislation made under the Lamfalussy process with the UK regulators ultimately just left to implement/supervise it), the UK regulators will have a significant increase in powers and responsibilities.

- This needs to be reflected in:

    - ensuring that the UK regulators are sufficiently resourced;

    - directing the regulators' rule making powers by clearly signposting the policy objectives in legislation;

    - increased scrutiny by Parliament and HM Treasury so the UK regulators have appropriate oversight; and

    - a practical and effective mechanism for firms and others affected to challenge situations where they feel a regulator is applying a rule in an unsuitable, disproportionate or otherwise inappropriate way.

However, we suggest that more thought should be given to the overall framework within which the regulators are able to make rules. Should the general philosophy be, as currently under FSMA, that once HM Treasury has set the regulatory perimeter the regulators are, broadly speaking, free to make rules as they see fit, having regard to their objectives and the regulatory principles (and the proposed new sectoral principles)? Or should the regulators only be permitted to make rules within an enabling statutory framework for each sector, setting out the general areas of permitted rulemaking and the objectives and principles that should apply? The scope of power, the direction as to what the rule is trying to achieve and the parameters within which the FCA has to work are quite different between the two options.

These mechanisms should apply to all the regulators' rules rather than just those deriving from or otherwise related to onshored EU regulation. That said, we think it is important to consider, going forward, whether any rule making proposals pose a significant risk to maintaining an existing equivalence assessment or obtaining a desired new one. This could be specifically factored into the law and rule making process or there could be a committee formed for this purpose.

What is your view of the proposal for high-level policy framework legislation for government and Parliament to set the overall policy approach in key areas of regulation?

We broadly support this approach. However, it will be important for the government and Parliament to carefully calibrate how they set the principles and overall policy approach in key areas of regulation. There is a balance to be struck. Whilst there is clearly some benefit to the principles being high-level as the regulators will have more ability to craft the detailed rules themselves, setting principles or the overall policy approach at too high a level risks there being too little accountability for the regulators when they formulate the detailed rules because it will be difficult to effectively judge the regulators against the intended approach. It may also make it difficult for the regulators (and regulated firms) to glean the real legislative intent behind the overall policy approach.

HM Treasury should also think carefully about how the area-specific policy principles compare with the general regulatory principles in FSMA, and the objectives the regulators seek to obtain as set out at a high level in their statutory objectives. They should make clear the purpose of each, and how the regulators should approach each layer, particularly in a situation where some of them might

point in different directions. It will be necessary for the overall policy approach in key areas of regulation to be set out at a more granular level that in the general regulatory principles or statutory objectives if they are to be useful. We think it is worth considering whether the sectoral principles might be better suited to secondary legislation and indicate the policy intent in a way which is similar to the recitals in EU legislation.

That said, in some cases, it may be appropriate for an element of a policy approach to a specific area of regulation to be set out in the general regulatory principles in FSMA or a regulators' statutory objectives due to its overarching importance. In these cases, government should ensure that this is the case to avoid accidental inconsistency between different areas of regulation. • Do you have views on how the regulators should be obliged to explain how they have had regard to activity-specific regulatory principles when making policy or rule proposals?

We would suggest that the regulators should be required to:

- explain their approach in their relevant consultation and policy documents; and
- report to a specific Parliamentary committee on a regular and structured basis.

One further point to consider in this context is the route by which the regulators make certain rules. The sophistication of the regime means there are circumstances where the use of a particular power might have an effect for which a different rule making process has been designed. For example, the FCA has proposed to transpose Article 1(16) of the Bank Recovery and Resolution Directive II (EU) 2019/879) into FCA rules in a way which effectively imposes a prohibition on selling subordinated eligible liabilities (TLAC) to retail investors with a portfolio of less than EUR 100,000. This ban will be achieved through the transposition by opting not to adopt various discretions which are available, and without adopting the mechanisms for deploying the product intervention power and the factors it requires to be taken into account. While this is a legitimate use of a power and we do not disagree with the outcome, it may be appropriate for the regulators to consider to the effect of their decisions and acknowledge where there is an alternative process for making them and, where appropriate, to have regard to the intended objectives and required factors under the other route. Parliament and HM Treasury also have some responsibility in trying to minimise the number of situations where this type of effect can occur by thinking about the other powers they have granted before creating new ones.

3 Do you have views on whether and how the existing general regulatory principles in FSMA should be updated?

We agree that if certain policy considerations are relevant to many areas of regulation, it is appropriate for these to be reflected in cross-cutting regulatory principles rather than to have multiple similar but different activity specific regulatory principles.

We also agree that it would be useful to have a regulatory principle which requires the regulators to have regard to the importance of accessible, easy to navigate rulebooks. We wonder whether the possibility of a principle which allows firms to take advantage of practices and innovations that minimise the compliance burden on firms, such as 'machine-readable' rules, should be a separate and additional principle rather than necessarily merging the two together.

We would strongly support the introduction of a principle to have regard to international standards and to avoid conflict and inconsistency with the regimes of other jurisdictions where possible. This could also refer to minimising the gold plating of requirements that implement internationally agreed standards without good reason.

We note the debate about factoring competitiveness into the regulatory objectives and the idea that it might feature in the activity specific regulatory principles for certain activities. While we appreciate the balance of arguments on the objectives, we anticipate that competitiveness may be a principle

that will be relevant to most areas of regulation and may therefore lend itself better to a cross-cutting principle.

4 Do you have views on whether the existing statutory objectives for the regulators should be changed or added to? What do you see as the benefits and risks of changing the existing objectives? How would changing the objectives compare with the proposal for new activity-specific regulatory principles?

The main issues identified in the Consultation as relevant to a general review of the appropriateness of the statutory objectives are (i) whether supporting the competitiveness of the UK financial sector should be reinstated as an objective and (ii) whether promoting competition should remain as only a secondary objective of the PRA.

We do not have strong views in relation to (ii). We have considered whether is it logical for competition to be a primary objective of the FCA but only a secondary objective of the PRA but we can see some logic in maintaining this differentiation given their respective focusses on conduct and prudential regulation.

In relation to (i), the concerns identified in the Consultation are dilution of focus on the core objectives and acceptance of a "light touch" approach. As noted in response to Question 3, we would suggest considering instead adding a new general regulatory principle in relation to competitiveness.

We would propose for consideration an alternative formulation for such a principle along the lines of "sustaining and promoting an environment where financial services can flourish in their global context". We believe this would give due recognition to the importance of maintaining the UK's key position in the global financial services markets at this critical time, but without the focus on competitiveness and the risks that might imply. In any event, competitiveness should not be seen as just ensuring that the UK is not at a disadvantage compared to other financial centres, but also that UK customers are able to access the best financial services in the world. This also ties in with the approach taken in the Financial Services Bill, which places global standards front and centre and requires the regulators to have regard to the likely effect of the proposed rules on the relative standing of the UK as a place for internationally active firms to be based or carry on their activities. Acknowledging the reality that competitiveness needs to be balanced with other regulatory objectives (and is in practice regardless of it not being an objective) would also enable the regulators' considerations to be transparent and subject to scrutiny. In terms of whether the introduction of new activity-specific regulatory principles have any implications for the statutory objectives, we believe the purpose of the statutory objectives would remain - to define the overall purpose and objective of the regulators, in order to enable them to set their strategy and inform their culture. Where the statutory objectives do not apply to all the relevant regulator's areas of competence, but only to certain fields of activity, there could be an argument for incorporating them into the activity-specific regulatory principles (e.g. the PRA's insurance objective applies to insurance business). Having said this, we believe the existing statutory objectives are sufficiently high-level and relevant beyond their most obvious rule sets to retain, leaving the activity-specific regulatory principles to be more granular.

The consultation also asks whether changing the objectives could be an alternative to the new activity-specific regulatory principles. This does not seem an attractive approach to us, since the statutory objectives and activity-specific principles would have different purposes: the former is to define the overall purpose and objectives of the regulators, the latter to convey the policy intention of Parliament in relation to specific areas of regulation. Trying to deal with both together risks the objectives and activity-specific principles being set at a level of granularity that does not achieve either purpose.

Having said this, there is a potential danger of confusion and conflict with multiple layers of objectives and principles: statutory objectives, general regulatory principles and activity-specific principles. It will be necessary to remain disciplined when framing activity-specific principles in order to retain focus and avoid confusion and to be clear about which takes precedence in the event of a conflict.

We anticipate there will be a temptation to add principles that may apply across the board when framing activity-specific principles – for example, the Financial Services Bill proposals on investment firm prudential regulation refer to having regard to international standards, which may be more appropriately included as a general regulatory principle. One way to relieve this pressure may be to highlight in the legislation any cross-cutting principles that are particularly relevant to the policy intention of the legislative provisions in question.

5 Do you think there are alternative models that the government should consider? Are there international examples of alternative models that should be examined?

While we have not undertaken a review of the models used in other jurisdictions, we are not aware of alternative models in other jurisdictions that do not have their own shortcomings. We are also conscious that each regime is likely to be somewhat bespoke to reflect its own arrangements for policy, law making and regulation more widely than just in relation to financial services. However, we agree that it would be useful to consider the models adopted in other countries and to consider borrowing and adapting aspects that would enhance our own.

As noted, one jurisdiction we are all quite familiar with is the European one, whose sectoral approach to financial services legislation is interesting in the context of activity-based principles. There are benefits to this approach in terms of organising the broad scope of regulatory activities into segments by reference to the types of firms they are most likely to apply to. This reduces the amount of legislation many firms need to follow in detail and provides a degree of signposting for those that are less familiar with the regime. On the other hand, it does not reflect the more complex reality that the activities of many firms span the subjects of more than one piece of legislation and drawing the distinctions too clearly either makes it complicated for such firms to comply with each or impacts on flexibility as to the types of activities different firms can perform. While a benefit of sectoral legislation should be the ability to make each regime specific to the particular characteristics of its incumbents, in reality there tends to be a pressure to ensure consistency between different regimes, which sometimes undermines this potential benefit. Our conclusion is that it is preferable to recognise that there is a core of cross-cutting rules (such as general principles, financial promotion rules and organisational rules) that should apply (broadly speaking and subject to exceptions) to all regulated business, but that it is clearly appropriate to set out specific codes (for example, in relation to conduct and regulatory capital) for separate sectors where appropriate. This mixture of cross-cutting rules and sectoral codes seems to work well at the moment within the existing FSMA and rulebook structure.

6 Do you think the focus for review and adaptation of key accountability, scrutiny and public engagement mechanisms for the regulators, as set out in the consultation, is the right one? Are there other issues that should be reviewed?

We believe the Consultation is right to focus on the extensive mechanisms that are already in place. However, we think it is important to consider whether there are any gaps that could be well served by new mechanisms. One such area that might merit consideration, either under this Consultation or elsewhere, is the reality of regulated firms and other persons being able to challenge the supervisory decisions of regulators in the day-to-day exercise of their powers.

As discussed under Question 9, there are opportunities for the industry to contribute to the development of new rules, and there are clear processes that the regulators must follow in relation to enforcement. However, between these two stages, there is a limit to the extent to which the regime provides a mechanism to challenge, or to otherwise obtain a review of a rule once it has been made or has begun to apply to a firm in situations where a firm feels a regulator has applied the rule to it in a way which is unsuitable, disproportionate or otherwise inappropriate.

We note that a separate review of the judicial review process is underway but there are a number of features to judicial review which mean that in practice it risks being regarded as neither a viable nor desirable solution for firms to pursue in connection with the development of rules and guidance by

the regulators or the application of existing rules or guidance to them. These include the fact that, in very broad terms, it is necessary to identify a decision of the regulators in respect of which the applicant is seeking judicial review and this can be challenging in the context of the general application of the rules to firms by their regulators.

In many cases, firms do not necessarily want to challenge formally a decision but they can sometimes find it difficult to understand the reasoning or even how much thought has gone into the decision in the first place. Where, having understood the process and the reasoning, they still consider that a rule has been incorrectly applied, it might be worth considering a simpler, quicker and less confrontational means of review. One possibility might be a two-stage process. The first stage might allow a firm or other affected party to address their concern to a committee that is internal to the regulator. The committee would reconsider the purpose and effect of applying the rule and consider whether it might make sense to grant a waiver or whether the rule even applies in the circumstances. If this does not resolve the issue, it could be escalated to a form of Complaints Commissioner who might be independent of the regulator, although would have to have enough technical knowledge or access to it to be able to determine whether the regulator's decisions were correct. The Commissioner could make recommendations to the regulators where appropriate and the regulators could be required to account to HM Treasury or Parliament as to how they have responded. A more effective mechanism could be a useful tool for both market participants and regulators. It could support the agility of the UK's regulatory framework, further calibrating rules to support stated policy objectives and doing so in a timely manner to ensure that the rulebooks are as effective as possible.

7 How do you think the role of Parliament in scrutinising financial services policy and regulation might be adapted?

As the Consultation notes, it is for Parliament to decide whether and how it will adapt its approach to scrutiny. We note that the previous work of the Treasury Select Committee in financial services has been highly influential and led to significant reforms of the regulatory regime. However, it has focussed on quite specific aspects of the regulatory framework, usually driven by a failure that has already resulted in detriment.

While it is clearly important to undertake a root and branch review of problems that occur with a view to improving the system going forward, it is not clear to us that the current model could achieve the level of scrutiny that HM Treasury suggests might be appropriate under the new framework, on either a prospective or a restrospective basis. We think it is important to recognise the level of focus and resource that would be required to ensure more systematic, proactive, constructive and therefore meaningful scrutiny of such a wide ranging yet specialist area of legislation and regulation. We doubt whether this could be achieved without a parliamentary committee specifically focussed on this area, which is allocated sufficient expertise and time to perform its role, with the commensurate cost that would entail. We do not think it is realistic for a non-specialist parliamentary committee to carry out a meaningful ex-ante review of proposed regulatory rules and they are better suited to ex-post reviews of particular areas where potential shortcomings have been identified.

8 What are your views on how the policy work of HM Treasury and the regulators should be coordinated, particularly in the early stages of policy making?

Coordination of policy work between HM Treasury and the regulators is already essential given the decisions HM Treasury makes about the regulatory perimeter. The regulators need to be confident about their ability to implement those decisions and their likely effectiveness and this is only likely to be possible if they have been involved in shaping the regime. The regulation of crypto-assets may provide a good example of the need for both parties to be working together and how they might do so in order to determine the appropriate solution in a particular area.

We also think that the allocation of powers carried over in retained EU law, particularly with regard to the UK's relationship with other countries and recognition of the equivalence of their regimes, creates an increased imperative for cooperation.

Therefore, in our view, the potential adoption of the new model described in the Consultation only creates additional reasons for making consultation and engagement between HM Treasury and the regulators more systematic. We believe those bodies are better placed to articulate how best this can be coordinated but we would advocate for as much public visibility over the process and at as early a stage as is appropriate in order that the industry can understand what is influencing regulation and has a chance to support its development in a practical direction. We support the increased use of remit letters and responses to them for this purpose and the inclusion of HM Treasury in the Regulatory Initiatives Grid.

We also recognise the more frequent publication of HM Treasury consultations in the financial services sector over recent months and trust that its responses will be as thorough as those published by the regulators.

9 Do you think there are ways of further improving the regulators' policy-making processes, and in particular, ensuring that stakeholders are sufficiently involved in those processes?

Overall, we think the regulators should be congratulated for the effort they put into the policy-making process, both in terms of the research they undertake to understand the problems and identify potential options, the diversity of views they seek to encourage to feed in and the relative transparency of the development in their thinking. That said, there are always improvements that can be made and one of the challenges may be to ensure that these achievements are not diluted when HM Treasury and parliament start to become more relevant again. In terms of the areas specifically mentioned, we believe the statutory panels play a useful role but that improvements could be made to facilitate their ability to reflect the views of the industries they represent. For example, if there were greater transparency over the way they operate and the issues they discuss with the regulators, they could more effectively gather and feed in the views of a wider set of market participants. However, we appreciate that transparency around details would have to be provided after the event in relation to issues that the Panels are discussing with the FCA at an early stage in the process since their purpose is to provide a safe and confidential forum to share ideas, concerns and options as to approach. We would think that holding the chairs of the panels accountable to Parliament would significantly change the nature of their roles in a way that is unlikely to be productive.

The consultation practices of the regulators are comprehensive in the areas they cover, the level of detail they go into and the feedback they provide to responses. However, responding to potential changes is time consuming and it can be difficult to appreciate in advance how certain changes are likely to impact. While many firms make an effort to feed into consultations that are important to them in one way or another, some firms do not contribute because they perceive that the regulators have already made their decision and their views will not make any difference. It is therefore important to continue to demonstrate where public feedback affects the course of potential changes.

However, we believe one area in need of improvement is the cost benefit analysis. We believe these need to be undertaken in a more scientific and objective manner and that they should be undertaken both prospectively before a change is introduced, as well as retrospectively as part of the review of the effectiveness of particular rules.

We agree that the UK regime would benefit from the introduction of more systematic review of regulator rules. It could improve on its use or retrospective review and potential adjustment of new or amended rules to ensure they are properly achieving their objectives without unforeseen consequences and in a way which is as efficient as possible. We appreciate that a number of the ideas mentioned in the Consultation would assist with this process but it is not apparent to us that HM Treasury has put sufficient emphasis on harnessing the potential of the new framework for this

specific purpose. As well as using the improved clarity of purpose and enhanced scrutiny mechanisms, it would be useful to gather experience from the regulators and industry on any problems encountered in practice along the way rather than waiting for the review to commence and if this could be done in an increasingly automated way using data already in the regulators' possession as the starting point, so much the better.

We accept that a review programme will require resource from both the regulators and the industry but we think that omitting it from the regime would be a false economy. This type of exercise should ensure that under-performing or redundant legislation is improved or removed from the statute books and address issues that would otherwise become problems requiring new legislation later down the line. We welcome the initiative for reviewing new legislation after 5 years although we think it might not be necessary to be quite so rigid and rather to judge at the time how important it is to reconsider a specific piece of legislation at that point.

As noted above, we do not think a parliamentary committee is likely to be the most effective route of scrutinising and challenging proposed regulatory rule making. We can see that the use of independent, expert reviewers to carry out more significant reviews of the regulatory regime might appear more attractive because of the expertise and focus that could be allocated to such groups, but we assume such exercises might be quite costly for all parties concerned. We also perceive some risk of duplication and inconsistency in an arrangement where individual investigations into discrete areas are undertaken without central coordination. While we agree that the introduction of an external independent scrutiny function is not without its own challenges, we believe this would have the advantage of continuity and stability in its work. We suspect that such a body would stand a more realistic possibility of becoming and being trusted as an expert in using both qualitative and quantitative data to review, analyse and predict the effect of proposed plans as against policy. With such a function, some of the other mechanisms mentioned above may no longer be necessary in due course.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

Karen Anderson
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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