DechertOnPoint

October 2011 / Issue 24

A legal update from Dechert's Financial Services Group

Draft UK Financial Services Bill and the New UK Financial Regulatory Structure

This update is based upon a *DechertOnPoint* summarizing the new UK financial regulatory structure and the current draft Financial Services Bill ("FS Bill"), subject to scrutiny in the UK Parliament. For further information, including detailed analysis of the draft FS Bill, please refer to our recent *DechertOnPoint* The Draft Financial Services Bill in the Context of the Proposed New UK Financial Regulatory Structure.

The New UK Financial Services Regulatory Structure

Introduction

Responsibility for financial stability in the UK has hitherto been shared by HM Treasury, the Bank of England (the "BoE") and the Financial Services Authority (the "FSA"), under what is known as the tripartite system. In June 2010, the Government announced that it intended to abolish the tripartite system. This will result in the FSA ceasing to exist in its current form, and the establishment of three new regulatory bodies by the end of 2012: the Financial Policy Committee (the "FPC"), the Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA"). These reforms have resulted from criticism of the performance of the tripartite system in the financial crisis of 2007/8 for not anticipating the crisis and not providing decisive leadership during it.

The Coalition Government's proposals for reforms have been set out in three key papers published by HM Treasury:

- A new approach to financial regulation: judgement, focus and stability (July 2010).
- A new approach to financial regulation: building a stronger system (February 2011).
- A new approach to financial regulation: The blueprint for reform (June 2011). This included a draft version of FS Bill—the primary legislation proposed to bring the core reforms into effect.

For further information regarding the UK Government's proposed new structural reforms, please refer to our July 2011 *DechertOnPoint* The Financial Regulatory System in the UK: HM Treasury's Latest Proposals.

The New Regulators

The Role of the Bank of England

The draft FS Bill proposes to increase the maximum possible term of non-executive directors of the BoE's Court of Directors (the BoE's governing body) to four years to ensure greater continuity, and to enable the Chancellor of the Exchequer to extend the terms of Monetary Policy Committee ("MPC") and FPC members by six months. In addition:

- Responsibility for regulating settlement systems and recognized clearing houses ("RCHs") will be transferred to the BoE

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(alongside its existing responsibility for payment systems). The FCA will retain responsibility for regulating recognized investment exchanges ("RIEs").

- The draft FS Bill also proposes new measures in relation to both RCHs and RIEs, including:
  - simplifying the procedures for making directions and revoking recognition, to enable quick responses to threats to financial stability;
  - financial penalties and censures for breaches of regulatory requirements;
  - rule-making powers;
  - a new power to order skilled persons reports and to appoint investigators (the latter currently only exercisable against RIEs); and
  - removal of the special competition regime in Part 18 of the Financial Services and Markets Act 2000 ("FSMA").
- Further substantive issues will be dealt with once the European regulation for the regulation of derivative transactions, central counterparties and trade repositories ("EMIR") has been finalized.
- The draft FS Bill will also make the changes initially proposed in relation to the regulation of settlement systems, including enabling HM Treasury to empower the BoE to issue codes of practice or make rules on specified matters.
- The draft FS Bill enables the BoE to apply for a court order to prevent or remedy compliance failures within payments systems.
- HM Treasury will be able to order an inquiry into possible regulatory failures in the context of the regulation by the BoE of systemically important infrastructure.

The Financial Policy Committee

The FPC will sit within the BoE. It will be responsible for macro-prudential regulation and will consider macro issues affecting economic and financial stability. It will respond to any such issues by directing the PRA (and, where necessary, the FCA) to take the necessary action, which may include the use of new macro-prudential tools. The FPC will not itself directly supervise any firms.

Responses to the Government's earlier consultation supported the Government's plan to establish the FPC as a committee of the BoE, and its objective remains as proposed—namely, to contribute to the objective of the BoE to protect and enhance financial stability, through identifying and taking action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system.

In exercising its functions, the FPC:

- may not act in a way that it believed would be likely to have a significant adverse impact on economic growth; and
- must have regard to proportionality, openness and international law.

The functions originally outlined for the FPC remain essentially the same—namely to:

- monitor the stability and resilience of the financial system, with a view to identifying and assessing systemic risks; and
- use the following tools to address those risks:
  - public announcements and warnings (e.g., to publicize a concerning trend in financial services);
  - influence of macro-prudential policy at the European and international levels;
  - recommendations to bodies other than the PRA and the FCA; and
  - powers over the PRA and FCA: to make recommendations, backed up by a comply-or-explain mechanism (e.g., that firms disclose certain information) and to direct the PRA and FCA where explicitly provided for by macro-prudential tools (e.g., variable risk weights and liquidity tools) designed in secondary legislation.

The FPC will not have direct powers over regulated firms. Directions and recommendations from the FPC to the PRA and FCA cannot be directed specifically at an individual firm. Given the concentration of the UK financial services sector, this may not prevent a measure designed to preserve financial stability more generally from in practice catching the behaviour of a very small number of large institutions.

The Prudential Regulation Authority

The PRA will be a subsidiary of the BoE. It will be responsible for micro-prudential regulation of those firms that the government believes should be subject to significant prudential regulation. These firms include banks, building societies, insurers, and certain investment firms considered to be of systemic importance. These firms are sometimes referred to as "dual-regulated firms," as they will also be regulated by the FCA for conduct purposes.

As regards the PRA's objective, some significant changes are proposed in the FS Bill, which include:

- Taking into account the views of the insurance sector, the Government has recognized that the distinct nature of insurance business should be recognized in the regulatory framework. The draft FS Bill makes explicit reference to the responsibilities of the PRA with respect to insurers in the creation of a separate insurance objective: "contributing to the securing of an appropriate degree of protection for those who are or may become policyholders."
- The PRA will be required to give guidance on two matters:
  - how the PRA intends to advance its objectives in relation to different categories of PRA-authorized persons or PRA-regulated activity; and
  - matters that it regards as primarily its responsibility, rather than that of the FCA. This guidance, together with guidance issued by the FCA, should make the division of responsibilities between the PRA and the FCA more transparent. The PRA must consult the FCA before issuing such guidance.
- A new section has been included to make clear that the new regime will not be operated on a "zero-failure" basis.
- A new provision provides that, where a rule proposed by the FCA or PRA is to apply both to mutual societies and other authorized persons, the regulator must publish with the draft rule a statement indicating whether the rule will affect mutual societies significantly differently from other authorized persons, and details of the difference.

The Financial Conduct Authority

The FCA will:

- be responsible for the conduct of business regulation of all firms, including dual-regulated firms;
- inherit the majority of the FSA's market regulatory functions, including the FSA's role as the UK Listing Authority (the "UKLA"); and
- be responsible for the prudential regulation of firms not regulated by the PRA.

The Government intends to give the FCA a number of powers in addition to those currently held by the FSA. These include powers to:

- make temporary product intervention rules, allowing it to block an imminent product launch or to stop an existing product;
- require firms to withdraw or amend misleading financial promotions with immediate effect; and
- publish details of the start of enforcement proceedings against a firm for rule breaches or compliance failings.

As regards the FCA's objectives and general approach, the Government is proceeding with its previous proposals for the FCA to have a strategic objective to protect and enhance confidence in the UK financial system, and with operational objectives to protect consumers and promote market integrity, efficiency and choice. The FCA will be required to discharge its functions in a way that promotes competition.

The FCA will have a considerable degree of discretion when determining whether to invoke its powers to ban, or temporarily impose requirements on products. The trigger will be when it appears to the FCA to be necessary or expedient for the purposes of advancing its consumer protection or competition objective. The draft FS Bill expressly states that the power cannot be used to advance the FCA's market integrity objective (unless permitted by an order of HM Treasury), in response to concerns that the power is unlikely to be appropriate for the protection of professional or wholesale customers. However, somewhat controversially, the FCA will be able to make temporary product intervention rules, valid for up to twelve months, without any prior cost-benefit analysis or consultation. Nevertheless, the draft

FS Bill contains some, albeit limited, safeguards on the FCA's use of these powers. The FCA will be:

- required to consult on and publish a statement of policy governing the circumstances in which it may make temporary product intervention rules;
- prohibited from making further temporary rules that are substantially the same as temporary rules that have lapsed within one year; and
- required to consult and issue a cost-benefit-analysis if it wishes to extend the temporary product intervention rules beyond twelve months.

The draft FS Bill also contains new powers for the FCA to direct a firm to withdraw or refrain from issuing misleading financial promotions with immediate effect, so as to prevent consumers from being misled. The draft FS Bill imposes a duty on the FCA to publish directions made under this new power, in order to increase the visibility of its activities and to clarify good and bad practice, and contains some safeguards that are intended to mitigate the risk of reputational damage to firms—namely, the FCA will:

- be required to warn a firm of its proposed direction action, and to consider representations before publishing any details of its action; and
- have discretion as to the contents of the direction (although it will have a duty to publish the direction).

As regards the competition powers of the FCA:

- the FCA will have a "wide competition mandate" so as to enable it to take "significant action in pursuit of competition" (such as the promotion of current account switching); and
- the draft FS Bill contains a new power for the FCA to refer to the Office of Fair Trading ("OFT") possible competition issues (for example, structural features in a market or potential collusive business practices) that may require technical competition expertise or resolution by the competition authorities. The OFT will then be obliged to respond within 90 days.

Publication of Warning Notices

The Government has remained committed to giving the FCA and PRA a controversial power (although not a duty) to publish the fact that a warning notice has been issued, and a summary of the notice. This is notwithstanding acknowledged concerns regarding reputational damage and the potential for consumer confidence to be undermined.

However, a number of broadly-based safeguards are contained in the draft FS Bill—namely that the regulators may not publish a warning notice if it would be:

- unfair to the person to whom the warning notice relates;
- prejudicial to consumer interests; or
- detrimental to the stability of the financial system.

Further, the new regulators will now be required to consult the person to whom the warning notice relates before making the publication. As the FCA will be conducting most enforcement activity, this tool is likely to be used primarily by the FCA in practice.

Coordination Between the Regulators

The new structure necessitates close cooperation and coordination between the new regulatory bodies, to ensure consistency of regulation and to avoid duplication of efforts. The Government intends to put in place structures, such as memoranda of understanding ("MoU"), formalizing the ways in which the regulators should cooperate.

Regulation of Dual-Regulated Firms

The PRA and the FCA will need to work closely together in respect of the regulation of dual-regulated firms, given the potential for regulatory overlap and confusion between the two regulators' respective roles.

Crisis Management Arrangements

One of the Government's main criticisms of the tripartite system's performance during the financial crisis was that regulatory bodies failed to identify the problems that were building up in the financial system and to address them adequately once the crisis broke. The Government intends to establish a new crisis management mechanism, which will set out the roles that HM Treasury, the BoE, the FPC and the PRA are expected to perform in a crisis.

The draft FS Bill sets out the legislative mechanism for coordination. In addition to prescribing communications between the Chancellor of the Exchequer and the Governor of the BoE, HM Treasury must agree an MoU

on the coordination and management of crises. However, there remains some potential for conflict of interest between the PRA in its role as prudential supervisor of regulated firms, and the BoE in the operation of the Special Resolution Regime. The draft FS Bill also proposes a number of changes to the Special Resolution Regime.

EU and International Issues

The jurisdictions of the new regulators do *not* fit neatly onto the jurisdictions of regulatory bodies outside the UK. In particular, the Government has been obliged to consider which of the PRA and the FCA should represent the UK at the new European supervisory authorities (the "ESAs"), as well as at international bodies, such as the International Organisation of Securities Commissions (the "IOSCO") and the International Association of Insurance Supervisors (the "IAIS").

However, the Government appears to recognize that EU and international reform will be equally significant for the changes taking place in the UK, and has engaged with its European and international partners on the global strengthening of the regulatory regime. Responses to the previous consultations were supportive of the Government's emphasis on the need for the UK to have a single, coherent and consistent strategy to deliver sound reform that complements the changes proposed to the UK financial regulatory framework. The Government has also stressed that while it has had some successes, such as in its negotiations on the Alternative Investment Fund Managers Directive, a number of challenges remain, especially concerning the new EU capital requirements legislation.

Related Reforms

It is envisaged that the PRA and the FCA will inherit the majority of the FSA's current powers and responsibilities. However, the Government is also considering making further reforms to the existing regulatory structure beyond the core reform of passing the FSA's powers to the PRA and the FCA. These include reforms to the Financial Services Compensation Scheme ("FSCS"), the Financial Ombudsman Service, and the Money Advice Service. As indicated above, the Government also intends to transfer regulatory responsibility for systemically important infrastructure (i.e., settlement systems and recognized clearing houses) from the FSA to the BoE.

Timeframe

The Financial Services Bill

In June 2011, HM Treasury published a draft text of the FS Bill, the primary legislation that will bring the core reforms into effect. The FS Bill largely amends existing legislation, and will make extensive changes to the FSMA, as well as to the Bank of England Act 1998 and the Banking Act 2009.

Pre-legislative scrutiny ("PLS") of the draft FS Bill has been taking place in Parliament this autumn, with the PLS Committee due to report on the FS Bill in December 2011. The Government aims to introduce the FS Bill formally into Parliament before the end of 2011.

The Government intends for the transfer of powers to the new bodies to be completed by the end of 2012, although the FSA's 2011/12 business plan stated that the Government expects the new authorities to become operational at the beginning of 2013. In March 2011, Hector Sants, FSA chief executive, suggested that transfer may take place in early 2013. However, in evidence given in March 2011 to the Treasury Committee of the House of Commons, the BoE Governor suggested that the deadline might be delayed until 1 March 2013.

Nevertheless, in a response to the Treasury Select Committee published in May 2011, the Government insisted that the end of 2012 remains its deadline. Even if the Government accepts the recommendations of the Independent Commission on Banking (the "ICB"), which were published on September 12, 2011, its view was that the timetable will allow this.

The Government has stated that the draft secondary legislation setting out the macro-prudential toolkit available to the FPC will not be published before scrutiny of the Bill begins, because the timetable for developing the toolkit "relies to a large extent on international developments in macro-prudential policy."

The PRA and the FCA

The FSA and the BoE will be publishing further papers on the PRA and the FCA, including:

- an FSA paper on the FCA's operating model, which will include further detail on its risk framework and its approach to transparency; and
- a joint BoE and FSA paper on how the PRA and the FCA will deliver operational coordination.

The Interim FPC

In February 2011, the Government established an interim FPC to undertake, as far as possible, the macro-prudential role of the FPC that is to be established in statute. A key role of the Interim FPC is to undertake preparatory work and analysis into potential macro-prudential tools. In its June 2011 white paper, the Government gave an indication of its timings for this work:

- The Interim FPC will provide the Government with an update on its work on potential macro-prudential tools later in 2011 (in time for the FS Bill's introduction). While the Government aims to introduce the FS Bill formally into Parliament before the end of 2011, the timing depends not only on the duration of the PLS but also on the length of time taken by the Government in considering the scrutiny committee's recommendations.
- The Interim FPC will report to the Government for a second time in the first half of 2012, after its meeting in the first quarter of 2012, and the Government expects that this will coincide with the FS Bill's committee stage in the House of Commons.

Transitional Arrangements

The FSA is currently preparing for the transition to the new structure. It is introducing a shadow internal structure this year, allocating FSA staff and responsibilities in anticipation of the creation of the FCA and the PRA. The first step, undertaken in April 2011, was to replace its risk and supervision business units with a Prudential Business Unit and a Conduct Business Unit.

What is Next?

Date	Proposed or Potential Development
23 November 2011	Meeting of the Interim FPC.
1 December 2011	Publication of minutes from the meeting of the Interim FPC on 23 November 2011.
16 December 2011	Deadline for the PLS Committee to present its report on the draft FS Bill.
Before the end of 2011	BoE and FSA paper on operational coordination between the FCA and the PRA.
Before the end of 2011	First report by the Interim FPC on its macro-prudential toolkit.
Before the end of 2011	First reading of the FS Bill.
First half of 2012	Second report by the Interim FPC on its macro-prudential toolkit.
Before the end of 2012	Expected date for Royal Assent for the primary legislation.
1 January 2013	The Government's current deadline for the completion of the necessary primary legislation and the transfer of powers to the new regulatory bodies.

The Draft Financial Services Bill

Scope

The draft FS Bill contains the core provisions for the Government's structural reforms, including the measures necessary to establish the new regulatory bodies: the FPC, the PRA and the FCA.

The draft FS Bill provides that the PRA has sole responsibility for securing an appropriate degree of

protection for the reasonable expectations of policyholders as to their returns under with-profits policies. The PRA will be required to consult the FCA, and the FCA will need to provide advice, on matters relevant to achieving an appropriate balance between the interests of policyholders and the prudential position of the firm. The Government is considering whether current provisions are sufficient or whether further explicit legislative provisions are required.

Generally, HM Treasury will specify in secondary legislation the activities that are "PRA-regulated activities" for the purposes of FSMA. The order will determine the scope of regulation by the PRA and the persons whom the PRA will regulate.

As indicated above, the FS Bill will make extensive changes to FSMA, as well as to the Bank of England Act 1998 and the Banking Act 2009. Although the majority of the FS Bill's provisions relate to amendments to other primary legislation, it also includes freestanding provisions in Part 3 (Collaboration between Treasury and the BoE, FCA or PRA) and Part 4 (Inquiries and investigations). The Government decided to amend FSMA, rather than to repeal it and redraft and re-enact it, as it believed that this would minimize the impact on regulated firms and other stakeholders.

In a statement made on September 12, 2011, in response to the final recommendations of the ICB, the Chancellor of the Exchequer suggested that some of the ICB's recommendations may be implemented in the FS Bill. There are likely to be other extensive additions and amendments to the FS Bill during its passage through Parliament.

Commencement Date

The provisions of the FS Bill generally will come into force on such date(s) as HM Treasury specifies in commencement orders. The FS Bill will become, after Royal Assent, the Financial Services Act 2012 and it extends to England and Wales, Scotland and Northern Ireland.

Consultation

The FS Bill largely replicates the existing FSMA consultation requirements for rules and makes no exception for rules originating from the EU, even where there may be little or no discretion as to implementation. The Government considers that it is important for the PRA and FCA to conduct their own assessment of the costs and benefits of proposed rules, as well as to keep track of the impact of regulation on UK firms.

- The draft legislation requires the PRA to prepare an analysis of costs and benefits of proposed rules as opposed to an "estimate" as currently provided for in FSMA. The PRA should strive to provide estimates where it is proportionate to do so.
- The PRA may choose how it meets its statutory duty to put in place arrangements for engaging with practitioners, so long as those arrangements are transparent.
- Unlike the FCA, the PRA will *not* be required to maintain a Consumer Panel.

Statutory Instruments to be Made Under the FS Bill

The Government envisages using statutory instruments to introduce certain aspects of the reforms, using powers under the FS Bill. The FS Bill also allows for HM Treasury to make specific future changes to the regulatory regime.

The instruments that may be made under the FS Bill by HM Treasury address the following issues:

- Prescribing the FPC's macro-prudential measures (new section 95K, BoE Act 1998).
- Amending the FCA's statutory objectives (new section 1F, FSMA).
- Specifying which regulated activities are PRA-regulated activities, and any consequent changes to the PRA's statutory objectives (new sections 2D and 22A, FSMA).
- Specifying whether a particular activity or transaction should be treated as financial assistance for the purposes of new section 2I of FSMA and clauses 45 and 53 of the FS Bill (new section 2I, FSMA; clauses 45 and 53, FS Bill).
- Amending the FCA's and the PRA's shared regulatory principles (new section 3B, FSMA).
- Specifying matters that are primarily the responsibilities of the FCA or the PRA (new section 3G, FSMA).

- Specifying the respective responsibilities of the PRA and the FCA for threshold conditions (new section 55C, FSMA).

- Extending the scope of the FCA's powers to make product intervention rules to include measures related to its integrity objective (new section 137C, FSMA).

- Limiting the FCA's powers to require the withdrawal of financial promotions (new section 137O, FSMA).

- Specifying which bodies should be treated as European Economic Area mutual societies (new section 138L, FSMA).

- Adding to or restricting the descriptions of authorized person who can be qualifying authorized persons for the purposes of the powers of the FCA and the PRA to give directions to unregulated holding companies (new section 192A, FSMA).

- Specifying the definition of the term "financial institution" for the purposes of the powers of the FCA and the PRA to give directions to unregulated holding companies (new section 192B, FSMA).

- Specifying the definitions of the terms "relevant requirement" and "appropriate regulator," for the purposes of Part XIV (disciplinary measures), Part XVIII (recognized investment exchanges and clearing houses) and Part XXV (injunctions and restitution) (new section 204A and revised sections 380, 382 and 384, FSMA).

- Specifying the rule-making powers of the PRA and the FCA in relation to the FSCS (revised section 213, FSMA).

- Adjusting the deadline by which the OFT must respond to competition requests made by the FCA under section 354D (new section 354D, FSMA).

- Specifying the commencement dates for provisions of the FS Bill (clause 69, FS Bill).

Summary of the New UK Financial Regulatory Structure and EU Comparison

HM Treasury's July 2010 consultation provided more detail on the reforms to the UK financial services regulatory structure originally announced by the Chancellor of the Exchequer in June 2010. For further information regarding this consultation, please refer to our June 2010 *DechertOnPoint* United Kingdom Regulatory Reforms: Twin Peaks Revisited?.

The New EU Structure

The new EU framework is now made up of two pillars: the European Systemic Risk Council (the "ESRC") and the European System of Financial Supervisors (the "ESFS").

The ESRC

The ESRC provides EU-wide macro-prudential supervision for the first time, in the hope that this will reduce the vulnerability of Europe's financial system to interconnected systemic risks. The ESRC's role will be to:

- collate and analyze data in order to identify risks arising from macro-economic developments;

- cooperate efficiently with the ESFS (see below) to ensure a smooth flow of harmonized micro-level data;

- issue warnings and recommendations where the risks identified are significant; and

- oversee implementation of those recommendations.

Warnings and recommendations may be issued to the European Union as whole, to specific Member States, or to the European or national supervisory authorities. These recommendations will not be legally binding, but any failure to follow an ESRC recommendation must be properly explained.

The ESFS

The ESFS comprises a network of national supervisors working with the new European supervisory authorities—namely, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority. These new supervisory authorities have substantially greater powers than the former Level 3 Committees (CESR, etc.) that they have replaced. The new supervisory authorities are responsible for:

- developing harmonized rules by setting out binding technical standards in specific areas on

the basis of criteria to be set out in EU legislation;

- drawing up guidelines to be applied by the national supervisory authorities;
- facilitating resolution of disagreements between national supervisory authorities and issuing a binding formal decision, if necessary;
- building a common EU supervisory culture;
- supervising entities with pan-European reach (e.g., credit rating agencies);
- ensuring a coordinated response in crisis situations;
- collecting micro-prudential information from national supervisors; and
- dealing with other countries on behalf of the EU.

The new structure reflects an important shift towards centralized authority for financial services regulation in the EU. Day-to-day supervision of firms will continue to be carried out by national supervisory authorities, and the UK Government has been assured that implementation of this structure will *not* empower the new EU institutions to affect the fiscal responsibilities of Member States. However, it is anticipated that both the ESRC and the ESFS will wield significant influence through the recommendations of the ESRC as it reacts to systemic risks, and through the harmonization of supervisory rules by the ESFS, such rules to be backed up by formally binding decisions where necessary.

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