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A legal update from Dechert's Financial Services Group

The Financial Regulatory System in the UK: HM Treasury's Latest Proposals

Officials have been at work for much of this year designing a new regulatory regime for the UK's financial services industry, due to be in place by early 2013.

Unlike the FSA's previous way of working, the new strategy will be based on a proactive, intensive and more intrusive approach. In the FSA's business plan for 2011-12 Hector Sants, its CEO, promised that what is now to become the new Financial Conduct Authority will:

- address structural difficulties in sectors and the marketplace as a whole which limit or impair consumer choice;
- deliver intensive supervision of firms to ensure they treat customers fairly, focusing on point-of-sale practices, the way financial products are designed and firms' governance and culture;
- intervene proactively, on a market-wide basis if necessary, when analysis reveals that a product will cause more harm than good; and
- ensure an appropriate level of redress and compensation when things go wrong, taking action against firms and individuals where necessary to deliver credible deterrence.

In this *DechertOnPoint*, we examine the latest proposals from the Government contained in HM Treasury's recent White Paper and draft Parliamentary Bill, released mid-June 2011 as part of a formidable 413-page package of reading material, on which responses and comments have been requested by the Treasury by **8 September 2011**.

The Government's White Paper

The White Paper, including draft legislation, entitled: "A new approach to financial regulation: the blueprint for reform", is a consultation which builds on two earlier Government publications:

- "A new approach to financial regulation: building a stronger system" (which was open for consultation between 17 February and 14 April 2011); and
- "A new approach to financial regulation: judgment, focus and stability" (which was open for consultation between 26 July and 18 October 2010).

Interestingly, the new White Paper does not propose any major structural changes to the proposed new financial services regulatory architecture set out in the earlier consultations. This latest consultation does, however, contain some additional details of the proposals and has amended some of the responsibilities and objectives under the new regime. In total, it does not seem to amount to a great deal despite the length of the documentation, and regulators will now be required to exercise judgments needed to ensure that the financial sector is stable and efficient. Thus the new regulatory regime appears to be more about a change of regulatory and supervisory culture than about regulatory change. It marks a move towards judgment-based regulation rather than light touch regulation for the future. What this really means in practice remains to be seen.

The Financial Policy Committee (the "FPC")

The FPC is the new Committee now established to monitor the financial system and to identify risks to financial stability. It will have the authority to make recommendations and offer advice to other new institutions responsible for day-to-day oversight and policy, and the power to intervene to ensure appropriate action is taken where needed to ensure financial stability. The main features of the FPC have been agreed to for some time. It will comprise a committee of the Court of the Bank of England ("the Bank") with the Governor (as chairman) and three deputy Governors of the Bank, two Bank executive directors, the chief executive of the Financial Conduct Authority (the "FCA"), four external members and a non-voting representative of HM Treasury. The FPC's role will be to contribute to the Bank's financial stability objective by identifying and monitoring systemic risks and taking action to address them. It has already been criticised as too strongly representing a Bank of England view. It must be remembered that one of the principal reasons why the Financial Services Authority was set up was the Bank's failure in the past as a financial regulator in a number of high profile cases.

The Bank of England

The Bank's own remit is also to be enhanced. Alongside the new FPC, the Bank will have other financial stability functions. Most significantly, it will have a clear responsibility for dealing with crisis situations, building on its responsibility for operating the special resolution regime for banks. This regime is also being revised, with HM Treasury proposing to make five minor changes designed to improve the transparency of the regime and to make technical improvements to it. These are:

- to require that reports about the operation of a bridge bank or a bank in temporary public ownership must include financial information that gives a true and fair view of the state of affairs of the bank;
- to require that the Bank makes a report to the Chancellor of the Exchequer about the exercise of the private sector purchaser tool, to be laid before Parliament;
- to remove an area of legal uncertainty by specifying that a property transfer instrument or order may modify terms of a trust only to the extent necessary or expedient to ensure that a transfer is effective;
- to allow property to be transferred back from a private sector purchaser, with the purchaser's agreement, (a power which might be used, for example, to remedy the situation where property is inadvertently transferred contrary to the commercial agreement of the parties involved in the resolution); and
- to enable HM Treasury to direct a person appointed as a bank administrator to comply with such measures as are necessary for the purposes of assisting the UK in obtaining the approval of the European Commission for any State Aid provided in connection with a resolution under the Banking Act 2009.

The Prudential Regulation Authority (the "PRA")

The PRA is being established, as a subsidiary of the Bank, to conduct prudential regulation of firms which manage significant balance sheet risk as a core part of their business, i.e., banks, insurers and larger, more complex investment firms. A key change to the originally proposed role of the PRA, announced in the Chancellor's recent Mansion House speech is the addition of a specific statutory insurance objective to the PRA's legislative framework. More detail on the future approach to insurance supervision has been published in a joint paper issued by the Bank of England and the Financial Services Authority which is beyond the scope of this article.

The PRA will thus be a specialist judgment-led regulator. It will have a much smaller staff than the FCA. Its approach will combine regulatory policy relating to both firm resilience (e.g., capital, liquidity and leverage) with resolution of firms when they fail. Again, the PRA's approach to supervision is to be judgment-led. The nature and intensity of supervision will depend on the risks posed by each firm. Whilst every firm will be subject to a basic level of supervision to promote and support their soundness and resilience, supervisory effort and resources will focus principally on the "big picture" issues with potential systemic impact. PRA supervision will thus seek to go beyond monitoring "tick box" compliance with rules, which some commentators have accused the Financial Services Authority of adopting as its approach to supervision in the past.

It is proposed that supervision by the PRA will be undertaken by senior, expert teams, whose role is to make forward-looking judgments about these issues and, where necessary, decide appropriate interventions. Unfortunately, most of the experts

prefer to work outside the regulator in the financial industry itself.

The Financial Conduct Authority (the "FCA")

The creation of the PRA will not only result in the establishment of an authority able to focus on the safety and soundness of PRA-authorised persons, but by enabling the separation of responsibility for prudential and conduct of business regulation for systemic firms, it also allows the FCA to be established as an authority with the remit and capability to specialise in protecting consumers and promoting confidence in financial services and the markets.

As an integrated conduct regulator covering retail, wholesale and market conduct, the FCA requires a wide statutory remit which encompasses the full breadth of these responsibilities. This is to be achieved through a combination of strategic objectives expressed in terms of promoting confidence in the UK financial system underpinned by operational objectives relating to consumer protection, promoting choice and efficiency, and market integrity. Sadly, promoting financial innovation in the UK does not appear to be high on the FCA's agenda. As an addition to the original proposals, the FCA will also have specific new competition powers to require the Office of Fair Trading ("OFT") to consider whether structural barriers or other features of the market are creating competitive inefficiencies in specific markets.

The FCA expects to take a more proactive approach to dealing with the conduct of financial firms than the former FSA, and will have a lower risk threshold for potential consumer detriment. The FCA will also take an "issues-based" approach to supervision, in the hope that it will be able to identify and deal with potential sources of consumer detriment early and effectively. This is a highly ambitious proposal as normally the industry is well aware of consumer detriment long before complaints are made and the regulator becomes fully aware of the situation. The FCA will also be provided with a wide range of new tools to support its role as a strong regulator based on protecting consumers. These include:

- a new power to intervene to impose requirements on (or ban) products;
- the ability to disclose the commencement of formal enforcement action against a firm; and
- a strengthening of its ability to tackle misleading financial advertisements.

The FCA's new power to "name and shame" firms before they have been found guilty of any wrongdoing, now contained in the draft legislation, is of particular concern. Those accusing the firms of misconduct will not be named, which is unusual. If a case were to be heard in court, both parties would be named. The FCA will have the power to make public the fact that enforcement action has been started against a firm even if no action ends up being taken, and yet is likely to be exempted from legal liability for the consequences of such action—for example if the firm becomes insolvent as a result of the negative publicity—unless it has acted in bad faith (which would be very unusual, and particularly difficult to establish, in practice).

The FSA published on 27 June 2011 a paper on the regulatory approach of the FCA, the aim of which is to set out the FSA's initial thinking on how the FCA will approach the delivery of its statutory objectives and on which the FSA welcomes comments by **1 September 2011**. The paper is also intended to provide input for the pre-legislative scrutiny and parliamentary debate on the Financial Services Bill and includes details on the following:

- the FCA's scope and the number of firms which it is expected to regulate, either solely or jointly with the PRA;
- the FCA's objectives and powers, including its approach to its new competition role;
- the FCA's regulatory approach, including details of its attitude to proactive intervention and how it will build on existing FSA initiatives, such as credible deterrence;
- the FCA's regulatory activities, including the main elements of the FCA's possible risk and supervisory frameworks; how the FCA will supervise markets, particularly in its role as the UK Listing Authority; and its approach to wholesale conduct; and
- how the FCA will co-ordinate with other regulatory authorities, particularly the PRA.

The FSA now intends to publish further proposals on the FCA's operating model which will include further detail on its risk framework and its approach to transparency.

Some Comparisons with the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States

President Barack Obama signed into law on 21 June 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), thereby effecting the most sweeping changes to the U.S. financial regulatory system since the 1930s.

The Act is primarily focused on improving the regulation and supervision of the financial institutions that were viewed as triggering the 2008 financial crisis, namely banking institutions, as well as other firms that acted as major players in the derivatives marketplace or were involved in subprime lending and securitisation of such loans. Nevertheless, the Act's extremely broad reach leaves very few financial services firms untouched.

The Act's provisions range from high-level structural changes, such as the creation of a Financial Stability Oversight Council and a Consumer Financial Protection Bureau, to detailed requirements for specified participants in the financial markets (including investment advisers, investment companies, broker-dealers and broadly defined "banking entities").

The effects of the Act will be felt by entities beyond those currently registered with the Securities and Exchange Commission ("SEC") as investment advisers, investment companies or broker-dealers. Many unregistered investment advisers that manage private funds will now be required to register with the SEC and, together with currently registered advisers, will be subject to greatly increased regulation and SEC scrutiny. Additionally, the so-called "Volcker Rule" adds restrictions that, with certain exceptions for permitted activities, prohibit a banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in or sponsoring a hedge fund or a private equity fund.

There is a clear tension in the US reforms between the apparent desire to demonstrate Congress' tough stance on Wall Street while at the same time avoiding adverse impact of the reforms on the financial industry and recovery in the broader economy. In contrast, apart from some reforms likely to be proposed by the Independent Banking Commission later this year, the focus in the UK is more on reforming the regulatory architecture rather than making more substantial changes to the scope and content of regulation itself.

Next Steps

Despite the length of the White Paper, there is little that is truly new in the latest consultation by HM Treasury. This is, however, the first time that draft legislation has been presented together with its explanatory notes. These require careful consideration. There are a number of areas which readers may wish to consider:

- Structurally, the new legislation will amend, amongst other legislation, the Financial Services and Markets Act 2000 ("FSMA"). Somewhat unhelpfully the draft bill as currently presented is simply the first set of proposed amendments to FSMA. This makes it even more difficult to discern the changes in the round. The Treasury has undertaken that it will publish a consolidated version of FSMA which should make consideration of the planned amendments easier. In addition, the FPC is publishing its first financial stability report.

- There appear to be mixed messages coming out of HM Treasury and the FSA regarding the role of competition in the financial services marketplace. The Treasury has stated that "the discipline imposed by competitive markets is a significant driver of good conduct by firms", which has led to the FCA being given a statutory duty to exercise its general functions in a way which promotes competition so far as is compatible with its strategic and operational objectives. This is in potential contrast to the statements made in the FSA's Feedback Statement 11/3 on product intervention which discussed how demand-side weaknesses in some financial services markets may inhibit effective competition that works in consumers' interests.

- As with the previous consultation by HM Treasury on regulatory reform, there are significant sections dealing with the authorisation of both individuals and firms. What has not so far been made clear is whether or not there will be an automatic grandfathering process from being authorised by the FSA to being authorised by the PRA and/or the FCA.

Responses and comments are requested by HM Treasury by 8 September 2011. It has also announced that it intends to publish a further consultation on the operational coordination between the proposed new regulatory bodies in 2011. In other words, concerns about duplication and conflict between the PRA and the FCA are unlikely to go unaddressed, thankfully.

Comment

Three conclusions seem possible at this stage:

- Protecting consumers will have a much higher priority under the new regulatory structure in the UK.
- Mis-selling by firms, such as the recent payment protection insurance debacles, will be fast-tracked by new regulators. The legislation should contain the power to deem some cases of widespread misconduct as causing serious consumer detriment and in such cases the new regulator will be able to fast-track complaints or take pre-emptive action to prevent misconduct and require firms to put in place a consumer redress scheme, including expedited compensation pay-outs.
- The UK's financial services industry will be facing further years of uncertainty as the new regulators are given powers to stop any business activity they deem too risky and apply different rules to different firms depending on their risk profile.

Many financial firms will be subject to the Financial Conduct Authority's new range of tools such as the new power to intervene to impose requirements on (or to ban) products and the strengthening of its ability to tackle misleading financial advertisements. This could alter the rules applied depending on how risky the FCA deems each firm to be. This comes at a time of the additional uncertainty that the industry will face even as it struggles with a raft of new regulations governing capital, liquidity, pay and solvency regimes. Thus unpredictability will remain an issue for firms going forward.

That unpredictability could be exacerbated by the responsibility of the new macro-prudential regulator the FPC for identifying where the economy is in its cycle and taking countercyclical actions to mitigate its highs and lows. The regulators' powers could thus vary throughout the economic cycle.

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