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HM Treasury publishes a consultation on reforms to the UK financial regulatory system

HM Treasury has published a consultation paper on the implementation of reforms to the financial regulatory system. These reforms include the abolition of the FSA in its current form, the transfer of its prudential regulatory function to the Bank of England and the transfer of its conduct of business function to an independent body.

The new UK Government's view is that the UK's existing tripartite regulatory system (comprising the Financial Services Authority (the "FSA"), the Bank of England (the "BoE") and HM Treasury) failed, among other things, to consider macro-prudential issues appropriately and hence to identify and mitigate the global economic imbalances, unsustainable funding and excessive debt which contributed to the recent financial crisis.¹ The Government believes that the tripartite system contains a number of flaws resulting in a considerable degree of regulatory underlap, as well as lacunas which means that elements of macro-prudential risk analysis and mitigation receives inadequate attention.

At the micro level, the Government considers that there was a tendency for a box-ticking approach for compliance with rules instead of in-depth and strategic risk analysis, which would have enabled the regulator to understand the risks that individual firms pose to themselves and to the wider financial system. No single institution had the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action.

¹ As noted in our earlier client publication published on 21 June 2010 "The UK Government Proposes to Change the Architecture of the UK's Financial Regulatory System": <http://www.shearman.com/files/Publication/b1b6978a-81c5-48ba-94f0-40fcb50484fe/Presentation/PublicationAttachment/53061dc0-6801-42c5-88a5-4eb140a4e0f9/FIA-062110-UK-Government-Proposes-Change-to-Financial-Regulatory-System.pdf>.

Financial Policy Committee

The Government will entrust macro-prudential regulation to the BoE through the creation of a Financial Policy Committee of the BoE (the "**FPC**"), which will have statutory responsibility for improving the overall resilience of the financial system and enhancing macro-economic stability. It will do this, broadly, by addressing aggregate risks, vulnerabilities and cyclical imbalances across the system as a whole.

More specifically, the FPC's role will comprise:

- i. monitoring the financial system to identify risks to stability (for example, assessing the activities of the other regulators to identify any financial stability implications that may derive from their actions and monitoring the BoE's infrastructure regulation, resolution arrangements for failing firms and its provision of liquidity insurance to the financial sector);
- ii. taking action as necessary to address any vulnerabilities or imbalances identified (for example, making recommendations to the newly established prudential and consumer regulators where the FPC believes that regulatory actions are required to protect financial stability); and
- iii. communicating issues to Parliament and to the wider public (for example, publishing six-monthly financial stability reports, summarising the systemic risks, vulnerabilities and imbalances that the FPC has identified).

The Government proposes to equip the FPC with powers to fulfil its macro-prudential remit, including requiring banks to hold additional levels of capital during credit growth periods (a so-called capital "buffer"), imposing an overall limit on the level of leverage financial institutions can assume, and limiting specific types of lending by imposing higher collateral requirements during times of unsustainable growth. The Government will continue to engage in ongoing international and pan-European discussions to develop effective macro-prudential tools.

The Government acknowledges that in providing the FPC with new policy tools in macro-prudential regulation, it will significantly increase the BoE's influence over the UK's financial system and wider economy. Therefore, the Government suggests that the FPC must provide a clear and transparent exposition of 'secondary factors' (such as the fiscal impact of its macro-prudential decisions and the objectives of other regulatory authorities) when pursuing its primary objectives. However, the Government acknowledges that there is little merit in creating a framework in which the FPC could not take effective action to meet its objectives because of excessive constraints imposed by secondary considerations.

The majority of the FPC's members will be BoE executives. The FPC will be chaired by the Governor of the BoE, and will include the BoE's existing Deputy Governors for monetary policy and financial stability, the BoE's newly created Deputy Governor for prudential regulation and the two BoE executives responsible for financial stability and markets. In addition, the chief executive of the newly formed Consumer Protection and Markets Authority (the "**CPMA**") will sit on the FPC to ensure that any systemic risks arising from the activities regulated by the CPMA are correctly identified. The Chancellor will appoint four further independent members from outside the BoE to the FPC, and HM Treasury will have a non-voting representative member.

The FPC will be a committee of the BoE without separate legal personality. It will meet at least four times a year and will publish a record of each meeting. In addition, there will be a clear line of accountability to the BoE's governing body (the Court of Directors) and Parliament will be given the opportunity to examine and scrutinise the FPC's six-monthly financial stability reports. The BoE's annual report, which HM Treasury lays before Parliament, will also cover the work of the FPC.

Prudential Regulation Authority

The Government proposes to transfer operational responsibility for prudential regulation from the FSA to the BoE. A Prudential Regulation Authority (the "**PRA**") will be established as a subsidiary of the BoE. The PRA will conduct prudential regulation of firms and implement the macro-prudential policies adopted by the FPC. It will have operational independence and thus the FPC will not have any formal power of direction over the PRA in relation to firm-specific decisions or operational matters.

The PRA will have the primary objective of promoting the stable and prudent operation of the financial system through the effective regulation of financial firms. Like the FPC, the PRA will be bound by statute to have regard to a range of secondary factors, for example, the objectives of other regulators and impacts on consumer and business lending. However, in the event that its primary and secondary objectives conflict, the PRA will be required to pursue its primary objective.

The PRA will be responsible for the authorisation, regulation and day-to-day supervision of all firms subject to significant prudential regulation. This is likely to include all banks, building societies, credit unions, broker-dealers and insurers. The PRA will also exercise judgments about the safety and soundness of financial firms, approve those individuals required to perform controlled functions within firms and raise levies to fund the PRA's activities. These functions will be delegated from the PRA's board to an executive committee, which, in the absence of conflicts of interests, may include non-executive directors of individual firms.

The PRA's board (chaired by the BoE's Governor, with the Deputy Governor for prudential regulation as chief executive) may not delegate the responsibility for making prudential rules for the firms it regulates. The Government is currently considering whether this function should continue to be subject to statutory processes, and if so whether the current rule-making mechanisms need to be simplified.

The consultation notes that effective supervision is required for regulators to gather the information needed for regulatory judgments. Therefore, the Government will ensure that the PRA has its own credible and effective supervisory and enforcement powers. Furthermore, by combining the PRA's management with that of the BoE, the Government intends that the supervision of UK financial firms will benefit from the expertise, experience and credibility of the central bank.

As a subsidiary of the BoE, the PRA will be accountable to the BoE's governing body with regard to its administrative functions, for example its budget and remuneration policy, and performance against its objectives. In addition, the PRA will be externally accountable to the Government, Parliament and the public, through its reporting requirements. The Government intends to adopt further accountability and transparency measures to reflect the significant public responsibilities with which the PRA is entrusted. The PRA will be subject to audit by the National Audit Office which will be able to report on the effectiveness of the PRA's performance.

Consumer Protection and Markets Authority

The Government recognises that prudential and conduct of business regulation requires different approaches and cultures, and thus the new CPMA will take on the FSA's responsibility for consumer protection.

The CPMA will regulate: (i) the conduct of all firms in the financial sector, including all firms authorised and subject to prudential supervision by the PRA, in their dealings with retail customers; and (ii) dealings in wholesale financial markets, including the conduct of all financial services firms, market service providers such as investment exchanges and MTF operators, as well as market conduct generally, including compliance with market abuse legislation. The CPMA will be responsible for the authorisation and supervision of all financial institutions not regulated prudentially by the PRA, and will also create the regulatory prudential framework for such firms. In addition, it will draft and enforce retail conduct of business rules.

The CPMA will achieve its overriding primary objective of promoting confidence in financial services and markets by protecting consumers through its consumer division and through promoting confidence in the integrity of the UK's financial markets. However, as with the FPC and the PRA, the CPMA will also have to take into account a number of secondary considerations, such as cooperation with the other regulators, compliance with current statutory duties of the FSA, and other public interest considerations.

The CPMA will be established as a limited company funded directly by the financial services industry. It will be governed by a board with a majority of non-executives appointed by HM Treasury and the Government's Department for Business, Innovation and Skills ("**BIS**"). There will also be an executive committee of the board, in which the CPMA's non-executive directors will be expected to participate in circumstances where they are not conflicted, which will have responsibility for supervisory and regulatory decisions. The Government is considering whether it would be practically advantageous or economically beneficial to establish the CPMA by adopting the same legal corporate identity of the FSA – i.e., a company limited by guarantee which falls outside governmental restrictions on staff remuneration.

The CPMA and PRA will each be responsible for taking decisions, approving individuals to perform control functions, supervision and enforcement, and for granting firms' permissions to undertake regulated activities, with regard to the respective activities which they each regulate. Therefore the two regulators will need to work closely together to avoid duplicating efforts or undermining the other regulator's authority. Coordination will be achieved through a number of formal processes, including cross-membership of boards to ensure ongoing information exchange and statutory memoranda of understanding ("**MoUs**") detailing the mechanics of day-to-day cooperation. Under the MoUs, each authority will be required to consider the objectives of the other when making regulatory or supervisory decisions, and the CPMA will be required to consult with the PRA in advance of taking any decision that could cause a firm specific financial stability risk, with the PRA's decision being final in order to ensure prudential judgment is reflected in the delivery of all regulation.

Furthermore, the CPMA and the PRA will work closely with the FPC to ensure that the FPC is kept fully informed of any developments that may have an impact on financial stability. However, as the chief executives of both authorities are FPC members, it is likely that such convergence will occur during the FPC meetings themselves.

Recently, the FSA was granted broad financial stability information-gathering powers by the Financial Services Act 2010 (the "**FS Act 2010**") to help it to identify, assess and mitigate threats to financial stability arising from current and future types of unregulated business. The FSA may impose specific information requirements on firms or individuals or make a broad request for information relating to, for example, a firm's trading strategy. The consultation does not elaborate on which body will exercise this power after the FSA's abolition.

The CPMA will take on the FSA's responsibility for the Financial Ombudsman Service and oversee the newly created Consumer Financial Education Body. The CPMA will also have responsibility for the Financial Services Compensation Scheme (the "**FSCS**"), which oversees the compensation of depositors and other consumers for firm failures. However, the PRA will monitor the FSCS in the event of large institutional failure, and thus it may be necessary for both the PRA and the CPMA to develop rules on the compensation and levies to be imposed on the different classes of firm which they regulate. Another option still being considered is for the FSCS to devise and administer all compensation schemes and levies for all classes of firm, working closely with the PRA on contingency planning and, for example, having a board member nominated by the PRA.

The regulation of consumer credit may also come within the remit of the CPMA. Currently, the responsibility for consumer finance is split between the FSA (regulating most consumer activity, including insurance, savings, first charge residential mortgages and deposits) and the Office of Fair Trading (the "**OFT**"), which is the licensing authority and enforcement body for regulated consumer credit, including personal loans and credit cards. This division has led to a number of firms being

jointly regulated, and bringing together the FSA's and OFT's consumer credit functions within the remit of the CPMA could simplify the regulatory regime. HM Treasury and BIS will publish a consultation later this year on the potential simplification of consumer credit regulation and whether it should be brought within the scope of the CPMA.

Financial Infrastructure Regulation

The Government confirms that a markets division within the CPMA will take the lead on all market conduct regulation, and will represent the UK in the European Securities and Markets Authority (the "**ESMA**"), the European supervisory body which will replace the Committee for European Securities Regulators. In addition to regulating the conduct of some market infrastructure providers such as investment exchanges and multilateral trading facilities, the CPMA will be responsible for participants in over-the-counter ("**OTC**") financial markets and those trading all other financial instruments and derivative contracts.

The regulation and supervision of settlement systems and central counterparty ("**CCP**") clearing houses will be transferred to the BoE, given the BoE's existing responsibilities for payment systems oversight. This reflects the systemic importance of these forms of infrastructure. The consultation stipulates that, in performing its representative role within ESMA, the CPMA will work with the BoE to ensure that the UK's interests are effectively represented. However, the consultation does not confirm whether the BoE will have a separate CCP representative role within ESMA if ESMA ends up being tasked with supervising CCPs at the European level.

The Government expects that the BoE's supervision of market infrastructure will follow the same general principles of cooperation, coordination and consultation as for any other type of regulated entity. Therefore the BoE will cooperate closely with the CPMA, acknowledging the CPMA's responsibilities for exchanges and OTC markets and for the market conduct aspects of settlement systems and clearing houses. The Government also notes that some individual firms may be subject to market conduct regulation by both the BoE and the CPMA. For example, where an investment exchange also operates a clearing function, the BoE will authorise and supervise its clearing functions but it will also be subject to the CPMA's on-exchange conduct of business regulation and supervision.

Furthermore, the Government will consider whether there is scope for rationalising the authorisation regime contained in Part 4 of the Financial Services and Markets Act ("**FSMA**"), which provides a single authorisation process for individuals, companies, partnerships and unincorporated associations seeking to carry on regulated activities, and the recognition regime in Part 18 of FSMA, under which exchanges, CCPs and settlement systems are regulated. There are no proposed changes to the separate regimes for the approval of operators of relevant settlement systems under the Uncertified Securities Regulations 2001 or for designated systems for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

Listing and Related Activities

The Government seeks views as to whether the FSA's role as the UK Listing Authority ("**UKLA**") could be merged with the Financial Reporting Council's existing functions relating to the provision of corporate information in the context of audit and corporate governance, or whether such a role should remain within the CPMA markets division. The Government acknowledges that "there is a strong case" for a powerful companies regulator and therefore has asked BIS to draft detailed proposals for consultation in due course.

Economic Crime Agency

In his Mansion House speech, the Chancellor announced the establishment of a new single economic crime agency (the "ECA"), which would assume the responsibility for prosecuting criminal offences, including those involving insider dealing and market abuse, which is currently within the remit of the FSA and other agencies. A recent Supreme Court case² has shown that the FSA has power to bring prosecutions for offences other than those listed in Sections 401 and 402 of FSMA, which gives the FSA power to institute proceedings for specific financial offences under separate legislation, including insider dealing, money laundering and terrorist financing. However, it is yet unclear as to whether the new ECA will be given such a broad power to prosecute financial offences, as the Government has confirmed that the establishment of the new ECA will now be the subject of a separate consultation in due course. Furthermore, possible concerns arise as to the overlap of the various proposed enforcement functions. Firms could face enforcement action from the PRA for breaches of prudential principles (which are often the basis for many FSA enforcement actions at present), from the CPMA for breaches of specific rules on market conduct, and from the ECA for breaches of the criminal law, with each competing to procure a scalp.

Crisis Management

The Government is in the process of devising a "crisis management framework" for monitoring risks to financial stability and managing such risks in the event of a crisis. The Government acknowledges that appropriate safeguards must be in place to ensure that conflicts do not arise between the BoE's role as a contingency planning and resolution authority and its operation through the PRA. Thus the BoE's Deputy Governor for financial stability, not the PRA's chief executive, will be responsible for resolution planning.

It is proposed that after the FPC has published its six-monthly 'financial stability report', the BoE's Governor will report to the Chancellor on financial stability and any regulatory actions taken by the PRA or the CPMA. A record of such discussions will be published. In addition, the BoE's Governor will have to notify the Chancellor as soon as public funds are to be called upon, and simultaneously the BoE and HM Treasury will work together to develop robust contingency plans to minimise the call on funds, while working to ensure financial stability. The Chancellor alone will decide on the use of public funds in whatever form, and will be accountable to Parliament for the authorities' crisis management strategy.

In addition, individual firms must implement "self help" strategies. Firms will be required to adopt recovery and resolution plans ("**RRPs**", also known as "living wills"), which will be pre-approved by the PRA. Furthermore, the PRA should be able to intervene and require a firm's management to take specific actions in the event that it fails to deliver actions detailed in its RRP. The FSA has already published detailed proposals on the implementation of RRP and has established a pilot scheme.³ The FSA's existing proposals stipulate that each RRP should set out the firm's plans for how it would respond to severe stresses and set out the steps that the firm's management would take in such situations. For each action identified, the firm would need to set out the process for deciding upon and executing its recovery plan. Furthermore, each firm would need to provide resolution information in the event of its failure, such as information on the segregation of client assets and the procedures by which segregated assets could be transferred to third parties. The FS Act 2010 provides for the FSA to develop rules requiring banks and investments firms to prepare and keep up-to-date RRP. The FSA has indicated that it intends to

² *R(Respondent) v Rollins (Appellant)* [2010] UKSC 39.

³ See our client publication entitled 'Financial Institution Recovery and Resolution Plans', dated 26 May 2010: <http://www.shearman.com/files/Publication/fcaef525-a0ee-4347-8563-9b837f2987b8/Presentation/PublicationAttachment/8c0763cd-a911-4109-9783-bf37469ec3a0/FIA-052610-Financial-Institution-Recovery-and-Resolution-Plans.pdf>.

consult further on RRP in 2010/2011. However, as yet there is no confirmation on whether the PRA, when established, will follow the FSA's proposals with regard to RRP.

The Government also intends to look at the special resolution regime ("**SRR**"), established by the Banking Act 2009, which provides HM Treasury, the BoE and the FSA with tools to protect financial stability by resolving failing banks and building societies. The Government will look to strengthen the accountability of the authorities exercising authority under the SRR, consider what further changes may be needed in light of the creation of the new authorities, and what improvements may be required to enhance safeguards and the overall effectiveness of the SRR.

HM Treasury will continue to represent UK interests in international fora, and prior to the restructuring of the UK's regulatory architecture, it will consider whether further clarification is required regarding each new authority's role in such international discussions.

Next Steps

The Government is proposing to present more detailed proposals and draft legislation for further consultation in early 2011. Certain advance measures will be adopted, including establishing the FPC by the autumn of 2010 and the reorganisation of the internal structure of the FSA in early 2011, to minimise the time needed for implementation when the final legislation is adopted.

Hector Sants has agreed to continue as the chief executive of the FSA during this transition period before becoming the chief executive of the PRA when the formal legislation receives Royal Assent. Mr Sants will oversee the implementation of the FSA's new "shadow internal structure" in the first quarter of 2011, which will allocate FSA staff and responsibilities in anticipation of the formal creation of the PRA and the CPMA. In addition, the BoE will assist the FSA in the preparation of a new operating model to address the structure, resource and appropriate supervisory frameworks for the PRA and the CPMA.

Commentary

There will undoubtedly be a great deal of upheaval in implementing these reforms. New protocols on regulatory co-ordination will have to undergo a period of trial and error before being settled. It could be argued that the reforms will not fundamentally alter the existing regulatory structure beyond changing the name of the FSA and moving existing personnel between institutions. This raises the question of whether the disruption occasioned by these reforms will be worthwhile. That said, the need for a systemic supervisory body is clear and the coupling of prudential regulation more closely with macro-economic and central supervision is an outcome that reflects emerging regulatory thinking around the world.⁴

It remains to be seen how the new UK structure will interact with the EU framework, which is also currently subject to change. In the EU, the proposal is for three bodies with (albeit limited) pan-European authority. One, the European Banking Agency ("**EBA**"), will regulate banks but not investment firms. The second, ESMA, will regulate investment firms and, it would appear, most aspects of conduct of business. ESMA will also regulate CCPs. The third, the European Insurance and Occupational Pensions Authority ("**EIOPA**"), will oversee insurance and pensions regulation. The EU split between

⁴ In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act provides for the establishment of the Financial Stability Oversight Council. See our client note: "Landmark Financial Regulatory Reform Legislation Passed By U.S. Congress" dated 20 July 2010: <http://www.shearman.com/Landmark-Financial-Regulatory-Reform-Legislation/>. In Europe there are proposals to establish a new body, the European Systemic Risk Board ("**ESRB**") to oversee and monitor financial stability across the European Union, make recommendations and issue alerts but without any enforcement powers.

banking and investment firm regulation is inconsistent with the UK's proposed split between prudential and conduct of business matters, which will mean that both UK regulators will need to interact with both European regulators.

The other point to note about the UK's proposals is that the BoE may wish to assert its old-style discretionary regulatory approach upon the PRA. This approach was traditionally based more on the exercise of discretion and less on the application of clear rules on capital and risks. This *modus operandi* will be somewhat limited by Basel, but there are nevertheless discretions embedded in the Basel and other applicable supra-national systems that will permit the PRA to behave in a more arbitrary way than the FSA has in the past. The exercise of discretion may be tempered to a degree by the availability of judicial review of decisions of the PRA, meaning that all action must be fair in terms of process and proportional. However, the threshold for court interference is quite high. Following such a severe financial crisis it is also difficult to envisage a successful challenge to a direction requiring an institution, for example, to hold higher levels of capital.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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