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Reforming the Framework for Financial Regulation in the UK

The UK's coalition government has published further details of its proposals to reform the structure of financial regulation.¹ The Financial Services Authority will be replaced with two new regulatory bodies by the beginning of 2013. The key change is that matters relating to the prudential regulation of 'prudentially significant firms', such as regulatory capital, will be moved to the Prudential Regulatory Authority, a new subsidiary of the Bank of England. The prudential regulation of other firms and conduct of business matters for all firms will be the responsibility of the new Financial Conduct Authority. Firms will need to develop a clear understanding of the revised structure and its practical impact.

Following the financial crisis, the effectiveness of the UK's existing tripartite regulatory system, under which the Financial Services Authority (the "FSA"), Bank of England (the "BoE") and HM Treasury were collectively responsible for financial stability, came under intense scrutiny. The UK's new coalition government has in particular reviewed the structure and considered the need for reform. One of the conclusions of this review has been that the tripartite bodies may have unduly focused on conduct of business issues within individual institutions (e.g. mis-selling), at the expense of identifying macro-economic developments which posed a threat to financial stability.

The government proposes to address the absence of an overall financial stability watchdog by the establishment of the Financial Policy Committee (the "FPC") within the BoE, with responsibility for 'macro-prudential' regulation, supervising the stability and resilience of the financial system as a whole. It also proposes to re-assign the FSA's current functions between two new regulatory entities:²

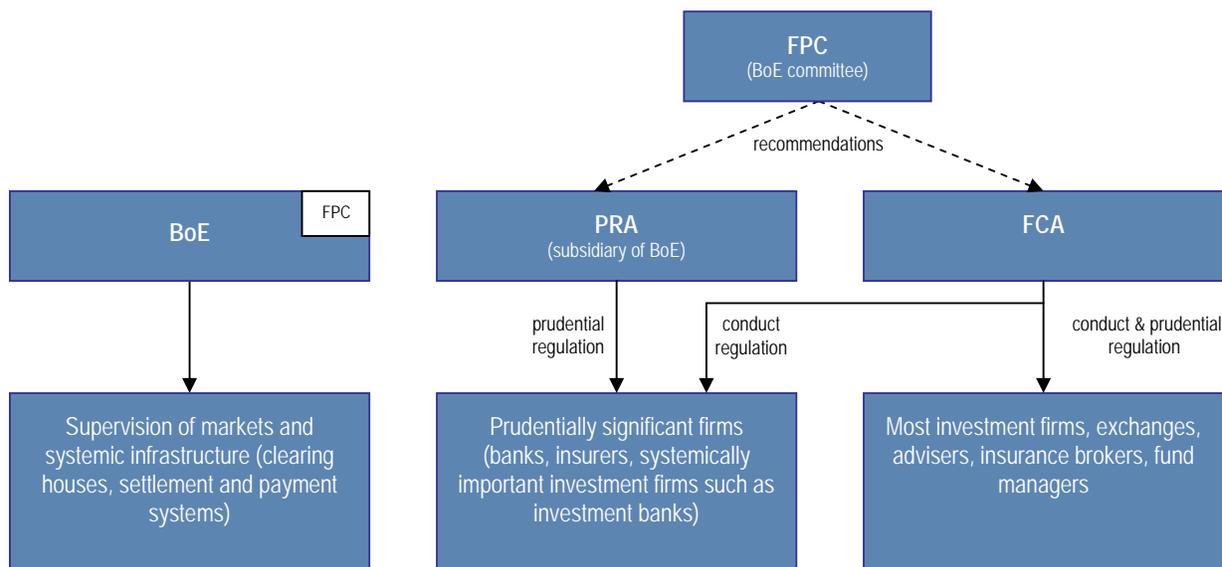
- the Prudential Regulation Authority (the "PRA"): a subsidiary of the BoE carrying out 'micro-prudential', firm-specific regulation of regulatory capital and related matters; and
- the Financial Conduct Authority (the "FCA"): (formerly proposed as the 'Consumer Protection and Markets Authority') effectively, the successor to most current FSA functions, responsible for the prudential regulation of firms outside the remit of the PRA and the conduct of business regulation of all firms within the financial services sector as a whole.

¹ For further information, you may wish to refer to our previous client note, "HM Treasury Publishes a Consultation on Reforms to the UK Financial Regulatory System", available at <http://www.shearman.com/hm-treasury-publishes-a-consultation-on-reforms-to-the-uk-financial-regulatory-system-08-05-2010/>.

² See "A new approach to financial regulation: building a stronger system", available at: http://www.hm-treasury.gov.uk/consult_finreg_strong.htm.

In addition, the BoE will supervise the systemically important elements of market infrastructure such as payment systems, settlement systems and clearing houses.³

The proposed new regulatory architecture and the roles of each regulatory body can be represented as follows:



It is currently unclear to what extent the establishment of the PRA and FCA will require changes to be made to the FSA Handbook in its present form. Both entities will have statutory powers to make rules that apply to regulated firms under their supervision and are likely to inherit sometimes overlapping parts of the existing FSA rulebook.

Objectives of the New Regulatory Bodies

The proposed objectives and competencies for each regulatory body are as follows:

- **FPC:** contributing to the BoE objective of protecting and enhancing the stability and resilience of the UK financial system. Identifying, monitoring and taking action to remove or reduce systemic risks at a macro level, with a view to protecting and enhancing the resilience of the UK financial system.
- **PRA:** in respect of "prudentially significant" firms, contributing to the promotion of the stability of the UK financial system. Promoting the safety and soundness of PRA-regulated entities.
- **FCA:** protecting and enhancing confidence in the UK financial system as a conduct of business regulator. Facilitating efficiency and choice in the market for financial services. Securing appropriate protection for consumers. Protecting and enhancing the integrity of the financial system.

Regulatory Principles

A number of regulatory principles have been established which will be common to the PRA and the FCA such as cost effectiveness, responsibility and transparency. Both regulators will be required to have due regard to efficiency and

³ No mention is made in the proposals however regarding the supervision of recognised overseas clearing houses but these will also presumably be regulated by the BoE.

proportionality in their use of resources, in the imposition of any burden or restriction on a regulated entity or in the carrying on of any activity. Such burdens must be proportionate to the benefits resulting from the burden or restriction. The responsibility of consumers for their decisions is also recognised as a constraint on the aims of regulatory action. Senior management of regulated firms will be responsible for ensuring compliance by individual firms with the regulatory framework. Both regulators will be required to disclose certain information so as to enhance market discipline and the transparency of regulatory processes and operations.

Financial Policy Committee

The FPC's functions will be to:

- monitor the stability and resilience of the financial system, with a view to identifying stability risks.
- use the following three 'levers' to remove or reduce risk:
 - public pronouncements and warnings (e.g. to publicise a concerning trend);
 - influencing macro-prudential policy in Europe and internationally; and
 - issuing recommendations to the PRA and FCA (backed up by a comply-or-explain process) and making recommendations to other bodies (such as HM Treasury and the BoE).

The FPC will not have any direct powers or oversight over regulated firms.

The FPC will be under a statutory duty to co-operate and share information with the BoE. It will collect information on, and analyse, the following matters:

- capital requirements (including the new countercyclical capital buffer and leverage limits under Basel III);
- liquidity requirements (as per the Basel III framework);
- forward-looking loss provisions;
- collateral requirements (loan-to-value requirements, 'haircuts' on repurchase agreements, and margin requirements on entities or other instruments); and
- stress testing of firms.

Prudential Regulation Authority

Scope: The PRA will be responsible for the prudential regulation of certain individual regulated firms. It will authorise and prudentially supervise all banks, building societies, credit unions and insurers, and will take responsibility for the prudential and organisational rules relating to the Lloyd's of London insurance market. In addition, the PRA will regulate certain designated investment firms where it determines that they could pose significant risks to the stability of the financial system. This is likely to mean that the main non-deposit-taking investment banks and other significant entities with a "dealing as principal" permission (classed as 'BIPRU €730k' firms) will also fall under its jurisdiction. Proposed secondary legislation will set out objective criteria for determining the extent to which other firms will be regulated by the PRA rather than the FCA. This structure is similar to U.S. proposals under the Dodd-Frank Act to regulate all systemically important firms in a similar way to banks.

Supervisory approach: The PRA will adopt a "judgement-led" or "purposive" supervisory approach. Firms will be need to comply with the 'spirit' as well as the 'letter' of the rules. It is envisaged that the PRA will make greater use of General Principles in its actions and will publish 'short statements' on the purpose of the rules respectively so as to enable firms

to understand the background methodology and rationale behind the rules and desired outcomes. The PRA will have rule-making powers. It will not have the power to make statutory guidance. The PRA will conduct a 'risk assessment' to determine the risks and likelihood of firm failures. It will carry out assessments of how firms would be resolved if they were to fail (taking into account 'living wills'), and the consequential impacts this would have on the financial system as a whole and on public funds. The PRA will be able to intervene to require firms to address any weaknesses it identifies within them.

The PRA will be required to take a 'whole firm' approach to considering applications for regulatory authorisation. It will only approve those firms which are prudently managed with a viable business model and effective controls for risk mitigation. Limitations and further requirements could be imposed on any part of a firm's business. The PRA will also consider whether individual employees or directors are fit and proper to take on their roles under a regime similar to the existing 'approved persons' system.

The PRA will have a veto for actions related to dual regulated firms, where the PRA and FCA are unable to agree on a course of action. The veto could be exercised if the PRA is materially concerned that a proposed action by the FCA would lead to a disorderly failure of a firm or firms, or wider systemic instability. As a result, the FCA is likely often to be the junior partner in relation to jointly supervised firms, which could lead to differences in the calibre of personnel that the two regulators are able to retain.

Financial Conduct Authority

Supervisory Functions to Conduct Regulation

Conduct of business regulation: The FCA will be responsible for the conduct of business regulation of all UK financial institutions, including those regulated prudentially by the PRA. It will also undertake prudential supervision for firms not regulated for such purposes by the PRA. As a result, the majority of firms will be entirely regulated by the FCA. The FCA will essentially be the successor to the current FSA. Many of the responsibilities performed by the current FSA, including, market regulation, the review of wholesale conduct by financial services firms, disciplinary action in relation to market abuse, and the supervision of recognised investment exchanges and other trading platforms which will be transferred intact to the FCA. Firms subject to prudential regulation by the FCA will typically be investment managers, investment advisors, brokers, providers of market trading infrastructure, non-bank mortgage lenders, mortgage brokers and insurance brokers. The FCA's role may be expanded further into consumer credit regulation, which is a function that may in due course be transferred to the FCA from the current incumbent, the Office of Fair Trading ("OFT"). The FCA's remit will also include regulating the conduct of branches of EEA firms set up in the UK. The FSA's UK Listing Authority function, for the approval of prospectuses for securities issues, will also become part of the FCA. The FCA is envisaged to apply more of an interventionist approach based on a greater use of judgement and issue-based supervision.

Enforcement: The FCA will have the power to take enforcement action through the use of a combination of the FSA's existing regulatory tools, such as the ability to impose fines and public censure, as well as new product-specific and competition powers. Where the FCA identifies problems with a particular product, product feature, or financial promotion, it may make rules or introduce new requirements to address the issue. These would include new product-specific powers to:

- enforce minimum product standards;
- restrict the sale of a product to a certain class of consumers or the volume of sales that can be achieved;

- prohibit the product or block an imminent product launch;
- make temporary product rules for a period of up to twelve months and also declare unenforceable contracts made in breach of its product intervention rules;
- direct a firm to amend or withdraw misleading financial promotions with immediate effect, and to publish the fact that it has done so (and, where a firm refuses to comply with a notice under this power, the FCA could exercise its supervisory or enforcement powers); and
- publicise the fact that a warning notice has been issued (signalling the start of formal enforcement proceedings).

Similar proposals in relation to retail products were recently published in the FSA's Discussion Paper DP11/1 "Product Intervention".

The FCA will be given new competition powers. Various options are being considered, including a possible power to make a market investigation reference to the Competition Commission or, as an alternative, the power to make a fast-track super-complaint to the OFT, which requires a response to be given within ninety days of the complaint. Under a separate initiative by the current government, the OFT is to be disbanded and merged with the Competition Commission, so changes in the competition regulation of the financial sector will need to reflect changes in those regulatory structures.

The overlapping functions of the PRA and FCA create a challenge for ensuring their effective coordination and in avoiding regulatory duplication or 'underlap'. Overlapping authority as to systems, controls, enforcement, the treatment of dual regulated firms and groups, create challenges in maintaining consistency of supervision. The regulatory jurisdiction of each body will need to be well defined so that firms know which organisation to report to and for what purposes. The potential for a 'grey area' between prudential and conduct regulation is of particular concern.

It is proposed that the PRA and FCA set out how they will co-ordinate their supervisory activities in a memorandum of understanding. There will be cross-membership of the boards of both organisations and provisions for how the PRA veto over FCA actions will operate. For dual regulated firms, the authorisation process will require the consent of both the PRA and the FCA. There is also a potential for regulatory arbitrage which will need to be addressed, in that the PRA and FCA may adopt different practices, seek to exercise their jurisdiction in particular ways or seek to attract business from the other.

From a practical perspective it will be important for firms to understand fully the objectives, role, approach and jurisdiction of each authority. Each authority will adopt different supervisory styles and will have statutory objectives, so regulatory issues and rule breaches may not always be assessed on the same basis, or indeed fit neatly into one or the other's domain.

Accountability Measures for the New Regulatory Bodies

Each regulatory body will be accountable for its actions, decisions and omissions as follows:

- the FPC will be a policy committee of the BoE's Court of Directors (the governing body of the BoE). As a result, it will be accountable to the Court of the BoE for the contribution it makes to the BoE's financial stability objective;
- the PRA, as a subsidiary of the BoE, will also ultimately be accountable to the BoE and its Court for administrative matters, including the approval of its budget and remuneration policy, its value for money and its performance against objectives. As an operationally independent regulator, the PRA will be accountable to its own independent board for performance against its regulatory and supervisory strategy, which will be set by its own board; and

- the FCA, as a standalone independent regulator will be accountable for its administrative, operational and strategic performance to its own independent board.

The government proposes to legislate for further institution-specific mechanisms for external accountability and transparency, as well as for measures that will apply across the regulatory framework. Ultimately, as public institutions, the decisions of all these bodies are potentially subject to scrutiny by judicial review.

Representation on European Supervisory Authorities ("ESAs")

Fitting the new UK regulatory structure into the new European regulatory architecture will be a challenge. The newly vested European regulatory bodies have been discussed in our separate client note.⁴ It is currently proposed that:

- the PRA will hold the UK's voting seat on the European Banking Authority and the European Insurance and Occupational Pensions Authority;
- the FCA will take over the FSA's seat on the new European Securities and Markets Authority; and
- of the UK's two seats on the European Systemic Risk Board, the voting seat will be held by the Governor of the BoE, with the non-voting representative rotated between the PRA, FCA and, possibly FPC.

These proposals highlight the fact that each ESA has a sector-specific remit, covering both prudential and conduct of business issues. By contrast, the competencies of the new UK regulatory bodies are not delineated by reference to industry sectors. As a result, there will be substantial areas of the work of the ESAs which are not the primary responsibility of the UK regulatory body holding the relevant seat. When this occurs, the UK government proposes that any other relevant regulatory body should be invited, as an observer, to the meeting, and that the primary body appointed to the seat should take account of the views of the other regulatory body in any vote. However, it remains to be seen whether the European regulators will allow such observers to participate in all meetings or how coordination of voting between the two UK regulators would work, particularly if they disagree with one another.

The allocation of other seats currently occupied by the BoE and the FSA are yet to be decided. For example, it remains to be seen whether the FCA or PRA should take over from the FSA at the International Organisation of Securities Commissions ("IOSCO"). The government has indicated that the FSA and BoE are best placed to decide how such seat transitions might best be managed.

Transitional Measures

The government intends to have the new authorities in place by January 2013. However, the changes require amendments to legislation. As a result, the timetable is subject to parliamentary processes. In the meantime, a temporary 'shadow' structure will be established to road test some key practicalities. An interim, acting FPC has already been established within the BoE. Also, the FSA, from 4 April 2011, has made changes to its internal organisation and management structure, replacing its Risk and Supervision business units with a Prudential Business Unit and a Conduct Business Unit.⁵

⁴ The New EU Financial Supervisory Architecture available at: <http://www.shearman.com/the-new-eu-financial-supervisory-architecture-10-18-2010/>.

⁵ Information on the new structure has been added to the FSA website, available at: <http://www.fsa.gov.uk/Pages/About/Who/Management/structure/index.shtml>. Other smaller changes are also taking place. For example, the Financial Risk Outlook has been bifurcated this year into the Retail Conduct Risk Outlook and a Prudential Risk Outlook to better reflect the distinct focus on prudential and conduct regulation.

The FSA's Business Plan for 2011/2012 considered that, under the current timetable, the FSA will probably continue to exist at least until the end of 2012 and will continue to carry out its existing regulatory obligations in the interim. The regulatory obligations of regulated firms will remain unchanged at least until 2013. Over the next 12-18 months firms will, however, need to develop an understanding of the new authorities, the new approach to supervision and the practical impact of their existence for firms in areas such as regulatory reporting and supervision.

This new, so called "Twin Peaks" type of regulation has already been adopted in jurisdictions such as the Netherlands and Australia. Whether it works well in the UK will depend on the close cooperation of the PRA and the FCA. There are likely to be instances where that cooperation is put under strain, for instance when sudden changes of direction are required in conduct of business by the PRA for micro-prudential reasons.

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.

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