SHEARMAN & STERLING

26 January 2023

REGULATORY ACCOUNTABILITY – EXPLANATORY NOTE FOR PROPOSED LEGISLATIVE AMENDMENTS

INTRODUCTION

1. This explanatory note relates to proposed amendments to the Financial Services Act 2012 ("**FSA 2012**") and the Financial Services and Markets Act 2000 ("**FSMA**"), which should form part of the Financial Services and Markets Bill (the "**FSM Bill**") (the "**Amendments**") and related statutory instruments[1]. The Amendments look to implement improvements to the current financial regulatory system in the United Kingdom in order to strengthen systems of regulatory accountability.

2. The explanatory note has been prepared in order to assist the reader in understanding the Amendments. They do not form part of the Amendments. The explanatory note should be read in conjunction with the Amendments. It is not, and is not meant to be, a comprehensive description of the Amendments.

BACKGROUND

3. During our membership of the EU, financial regulation developed enormously, but the methods of accountability in the U.K. did not. As things stand, the Treasury Select Committee oversees our regulators at the macro level. However, there is a minimal role for our judiciary. Regulators' decisions can be challenged in the Upper Tribunal, but such challenges are relatively rare and rarely successful. There is no cost-effective legal means for consumers to challenge firms' breaches of rules which cause them loss. When made effectively, such challenges give rise to case law precedent in a way which provides greater certainty and predictability to other consumers and industry.

4. Significant concerns have developed in the market that the Financial Conduct Authority (**FCA**) and Prudential Regulation Authority (**PRA**) have supervisory powers which are too wide-ranging and which are not subject to effective checks and balances. There are recent high-profile instances of the FCA being found to have acted unlawfully in its rulemaking but the FCA has ignored such findings. For example, the FCA's Remedies Statement dated 16 June 2020 was found to have been unlawful in various respects, in that it did not accord with the FSA 2012 and had been introduced without following the statutory process.[2] However, the FCA refused to accept the findings of the Financial Regulators Complaints Commissioner and the Remedies Statement therefore still stands.

5. As mentioned above, legal challenges by firms against regulators are currently rare, due to many firms' concerns about detrimental effects on their ongoing "relationship" with the regulator that supervises their business. This ultimately deprives both regulator and firm of the legal certainty that case law would bring to the exercise of regulatory power. Such challenges are also rarely successful.

---

[1] In order to support the Amendments, certain statutory instruments have been prepared: (i) a new First Tier Tribunal and Upper Tribunal (Chambers) (Amendment) Order 2023, which would amend the First Tier Tribunal and Upper Tribunal (Chambers) Order 2010, providing for a Financial Services Chamber to be created within the First Tier Tribunal system and for the functions of this Financial Services Chamber; (ii) a new Qualifications for Appointment of Members to the First Tier Tribunal and Upper Tribunal (Amendment) Order 2023 to amend the Qualifications for Appointment of Members to the First Tier Tribunal and Upper Tribunal Order 2008, providing for the appointment of financial services and markets specialists to the Financial Services Chamber; and (iii) a new Tribunal Procedure (First Tier Tribunal) Financial Services Chamber Rules 2023, providing for the procedures of and handling of hearings by the new Financial Services Chamber. These legislative changes are not discussed in detail in this explanatory note.

[2] The-Complaints-Commissioner-Final-Report-LCF-15.02.2022.pdf (frccommissioner.org.uk).

6. The FSM Bill in its unamended form heightens the above concerns in the market. This is because it transfers the rule-making powers held by EU institutions to the U.K. regulators, but without giving the U.K. Parliament additional powers as a check and balance on this enhanced regulatory power.

7. The Amendments therefore seek to enhance the role of the judiciary, so as to provide an effective check and balance on the exercise of regulatory power, whilst preserving the regulators' freedom to pursue their statutory objectives. In essence, they seek to strike a correct balance between regulatory autonomy and the rule of law in the exercise of regulatory power.

8. The proponents of the Amendments believe that they will, over time, help make the U.K. financial markets the best regulated in the world. They will improve the competitiveness of U.K. financial markets because they will improve the predictability and consistency of regulatory action. The new framework they provide, i.e. for the judiciary to clarify through case law how regulatory rules apply to the financial markets, will attract further financial business to the U.K. and lead to wider ranging and innovative financial products being available for U.K. consumers.

THE PROPOSALS

7. In light of discussions with industry and with consumer groups, the following adjustments are proposed which provide for the required accountability and consistency of the regulators in the future financial regulatory framework.

    a. *Requiring common law disciplines to be observed in rule-making.* Financial regulators do not have the same long tradition of Rolls-Royce rule-making that Parliament does. These Amendments require the regulators to maintain the high standards of clarity, predictability and certainty achieved by Parliamentary counsel, and to apply the same common law principles of interpretation to their rules and guidance. Those standards will ensure a market participant knows what the rules mean and how to comply with them.

    b. *Independence of regulators' decision-making bodies.* The ultimate enforcement decision-making bodies of the FCA and PRA are at present semi-autonomous and their procedures are ill-defined. The amendments ensure the independence of the Regulatory Decisions Committee (**RDC**) from the FCA and the Enforcement Decision Making Committee (**EDMC**) from the PRA and require them to apply to their decision-making the same common-law based methodologies mentioned above: reasoned decisions, clearly anchored in the facts of the case and in the applicable rules, so that the outcomes are consistent and predictable.

    c. *Right of appeal to Upper Tribunal on common law disciplines.* Decisions of the FCA and of the PRA can currently be challenged in the Upper Tribunal (**UT**). This is a suitable independent judicial body, but the legislation governing UT proceedings should ensure that the benefits of valuable case law permeate through the entire regulated market: when deciding a matter relating to regulatory conduct, the UT will now have specific regard to whether the regulator has acted in line with the proposed predictability and consistency objective and the UT should, in certain circumstances, make its own determinations in line with that objective .

    d. *Proper legal processes for consumer and small business disputes, giving rise to case law precedent, predictability and consistency in the application of the regulators' rules.* Consumer and small business disputes with financial services firms brought before the

Financial Ombudsman Service (**FOS**) are not at present primarily resolved in accordance with the law but are instead addressed based upon a different concept of "fairness." This creates risks for firms, who can act lawfully but still be found liable. These amendments adopt the Treasury Select Committee's proposal of October 2018 to create a First Tier Tribunal (**FTT**) to resolve consumer-firm disputes according to the law (which includes legal requirements on firms to treat customers fairly). At present, such disputes fall into a gap between the courts (where disputes can be costly and lengthy) and the FOS (where the outcome of a dispute may be unpredictable and which does not produce case law that is beneficial to the market).

The amendments preserve the critical role of the FOS in supplying easily-accessible redress to consumers. However, it will in future apply the law when doing so, including all the substantive fairness obligations contained in existing and future regulatory rules and consumer-protection legislation. It will do so by means of adjudication of the disputes which come before it, so as to provide a ready source of case law on the meaning of regulatory rules. Adjudication has been used with enormous success in the construction industry for two decades to provide a quick resolution of disputes according to the law. The FOS will be renamed the Financial Adjudication Service (**FAS**).

In the financial services context, FAS adjudication should primarily remain an investigatory process (as is currently the case with the FOS), although an adversarial approach may be adopted in the determination of a complaint as the adjudicator considers appropriate.

The consumer will be able to take their complaint on from the FAS to the FTT as of right if they seek an authoritative determination of their complaint. The respondent firm will also be able to do this with the FTT's permission, which the FTT will grant only if the consumer's financial position is adequately protected by the firm. That allows the firms to obtain binding precedent from the FTT where it is important to the market. However, experience in the construction industry suggests 90% of those who go to adjudication accept its result.

e. *Binding independent recommendations.* The Financial Regulators' Complaints Commissioner (**FRCC**) is able to make non-binding recommendations upon complaints about regulator conduct. The amendments would enhance the FRCC's powers, making its decisions binding, and would prohibit the regulators from making rules about their own liability. These amendments follow on from the FCA's recent decision to maintain a Remedies Statement which had been found to be unlawful in the FRCC's case concerning London Capital & Finance.

THE PROPOSED LEGISLATIVE AMENDMENTS

COMMENTARY ON SECTIONS

DIVISION 1 - RULE MAKING AND APPROACH OF REGULATORS

Sections 1B(4B), 1EC, 2H(1)(c), 2H(1C), 2H(1D) and 3RE(5) FSMA: Duty to draft clear and focused rules

8. This section adds a statutory obligation on the regulators to produce rules which meet basic common law criteria, such as clarity, certainty and predictability. This will ensure that the rules can be challenged if they fail to meet those minimum standards.[3] If any rules are struck down by the courts on these grounds, the regulators have the statutory power to introduce emergency new rules, to address (going forward) the conduct which their rules had inadequately addressed.[4]

Section 137GB FSMA: Common law, not EU, interpretative principles

9. This section makes clear that the common law approach to interpretation, as opposed to a European civil code purposive approach, applies to the regulators' rulebooks, guidance and other materials. The common law approach to interpretation of the words on the page uses the methods of the Interpretation Act 1978 in such a way that results in a clear and predictable meaning for those rules.[5] This would align with the proposals in the Retained EU Law (Revocation and Reform) Bill.

Sections 1B(4B), 1EC, 2H(1)(c), 2H(1C), 2H(1D) FSMA: Additional secondary objective

10. This section introduces a new statutory objective, requiring the regulators to act predictably and consistently in applying their rules. The regulators' statutory duties are already being amended to introduce a pro-competitiveness element and in other ways. This additional change would provide a benchmark against which the regulators' behaviour can be challenged and adjudicated. The requirement for consistency is only a positive one—i.e. it could not be invoked by saying other firms have not been disciplined for the breach, since the regulator needs to be able to let certain matters pass, for instance if in the wider context behaviours have or are likely to change.

Section 133C FSMA: Deference to judgments of firms

11. This section provides that where a firm exercises judgment in complying with a regulatory rule, and does this reasonably and in good faith, but its supervisor disagrees, then the firm would also be entitled to apply to the Upper Tribunal for a declaration that the firm's decision was reasonable. Such a declaration would serve as a protection for the firm and its senior managers against liability for a breach of regulatory rules resulting from that decision or judgment of the firm in relation to such acts or decisions that were the subject of the supervisory decision.

Section 137A and 137G FSMA: Principles to cease to be a stand-alone cause for enforcement action

---

[3] The court/tribunal would need to consider issues such as: whether a rule which did not meet the new test would be invalid from the start, or only from the point the court/tribunal strikes it down, how a rule would be treated which applies clearly in one situation, but less clearly in another and how the potential unenforceability of some of the rules plays from the viewpoint of legal certainty. The best approach would be that the rule remains valid but could only be used for something that is clearly caught. This is also the approach a court/tribunal is likely to take.

[4] They have the power under section 138L of FSMA to make rules without delay.

[5] The common law version of the purposive method of interpretation would be maintained, which involves looking at background papers to see what Parliament must be presumed to have intended.

12. This section provides that the Principles can be used as the basis for enforcement or indeed redress only if the standard sought to be enforced can be logically derived from the Principle, or if case law exists or formal guidance has been issued which makes clear the interpretation given by the regulators at the time of the conduct in question. For example, in the (former) Financial Services Authority's redress guidance for claims over the mis-selling of payment protection insurance,[6] which was challenged unsuccessfully by judicial review[7] (though not specifically on this ground), it could properly be said that non-*pro rata* refunds of policies surrendered early could logically be concluded to be a breach of the Principle of treating customers fairly. But the regulator could not properly assert, for example, that the Principle could benefit a non-customer. It might be noted, however, that clarity is still helpful: a substantive rule requiring *pro-rata* refunds on early surrenders would have saved a lot of trouble by avoiding debate on the point.

Section 1EC(2)(b) and 2H(1D)(b): Express prohibition of penalising firms for legal challenges

13. This section provides that a regulator shall not treat a firm or individual in an adverse manner (i.e., by penalizing the firm or individual or allowing their ongoing supervisory relationship with the firm or individual to be affected) because the firm or individual (or a connected person) has challenged the regulator's decision-making or other conduct.

DIVISION 2 - ENHANCEMENTS TO REGULATORY COMMITTEES

Sections 395A to 395H FSMA: Full independence of and statutory footing for the FCA Regulatory Decisions Committee (RDC)

14. This part establishes the RDC as fully independent (in particular from the FCA and PRA) with its rules provided for in statute. This is because full independence should be required if reliance is to be placed on the adjudicative nature of the decisions made by the RDC (e.g., withdrawal of permissions, prohibition orders and fines).

15. At present the chair of the RDC is an FCA employee,[8] and the RDC's existence, processes and decision-making is currently established in the FCA rules.[9]

16. Instead, this part now sets out the rules of the RDC in greater detail to specify (i) a clear link between the RDC's decision making and the statutory duties and objectives of the regulators;[10] (ii) an express

---

6 *The assessment and redress of Payment Protection Insurance complaints: Feedback on the further consultation in CP10/6 and final Handbook text*, FSA, PS 10/12, August 2010.

7 *British Bankers Association, R (on the application of) v The Financial Services Authority & Anor* [2011] EWHC 999 (Admin).

8 DEPP3.1.2. The employee is outside the executive management structure and is accountable only to the board. The reason behind this was to bring the RDC within the statutory exemption from liability in damages, which would not apply to an independent contractor. The RDC has no independent status because the designers of FSMA wanted a much less quasi-judicial approach at the regulator, with decisions taken by the executive and a fair hearing provided by the Tribunal. The RDC is effectively a hangover from the decision-taking committees of the previous self-regulating organisations. As such, this structure needs to be amended more to ensure the RDC is fully independent, cannot be liable in damages and can nevertheless meet in private.

9 DEPP3.

10 The result that the RDC is not required to operate under the same duties and objectives as the regulator was intended. The aim was that it should decide cases on the evidence rather than substituting its own view on policy issues, such as what is needed to protect consumers. The RDC is not set up with the requirements of public consultation etc. associated with policy-making. However, experience shows that the RDC should now be given a wider remit, since neither it nor the Upper Tribunal are really examining the cases with sufficient rigour.

need for predictability, consistency or accountability;[11] and (iii) that a reasoned account will accompany any decision which may be published.

17. In addition, when carrying out its functions, if the RDC reviews or makes a decision in relation to the FCA or PRA, it will consider whether the regulator has complied with the duties and statutory objectives imposed on it in relation to the relevant act or decision.

18. This part also provides for the RDC's immunity from damages, requirements for the RDC to consult practitioners and authorised firms, and for the making of further rules in relation to the RDC, its functions and procedures.

Section 395I to 395P: A statutory footing for the PRA Enforcement Decision Making Committee (EDMC)

19. These sections make equivalent changes to the position of the PRA's EDMC (save that the EDMC is already technically independent). This has similarly been proposed due to the nature of the decisions made by the EDMC and the reliance sought to be placed on those decisions.

DIVISION 3 - ENHANCEMENTS TO REGULATORY ACCOUNTABILITY

Section 133 and 133A FSMA: Proceedings before Upper Tribunal

20. These sections have been amended so that, when determining a reference or appeal in respect of FCA or PRA decisions, the Upper Tribunal shall consider whether the decision-maker has acted in accordance with the predictability and consistency objective (in relation to the specific conduct forming the subject of the regulatory decision or the application of the particular relevant rule) and make its determinations accordingly.

21. The discounts for early settlement offered by the regulators to firms subject to enforcement decisions should also be reduced to 10% under The Enforcement Guide within the FCA Handbook. The present 30% discount is one of various factors as to why firms are reluctant to challenge enforcement action.

Section 138D: Actions for damages before the First Tier Tribunal

22. This section provides that the newly formed Financial Services Chamber of the First Tier Tribunal (described further in paragraphs 25 to 27 below) shall hear actions in relation to customer-firm disputes, including matters where the new adjudication scheme has issued an interim-binding decision.

23. Actions under this section may be brought by a "qualifying person," rather than the previously used category of "private person," who are currently entitled to claim before the courts. A qualifying person means someone who is an eligible complainant for the purposes of existing FOS, and anyone else prescribed as such by the Treasury.

24. When hearing an action, the First Tier Tribunal shall apply the relevant legislation, (for smaller claims) regulatory rules (including Principles), and common law, and will have the same powers as the FAS in disposing of any action before it.

---

[11] The reasons for the current position on the RDC's accountability are similar to those relating to the statutory objectives (see preceding footnote). The fact that the RDC is not accountable for its decisions any more than a court would be is a feature of its independence and limited role. However, as with the statutory objectives, greater rigour is now needed and adjustments should be made.

Article 2A, First Tier Tribunal and Upper Tribunal (Chambers) Order 2010: New First Tier Tribunal

25. This statutory instrument provides for the adoption of a new First Tier Tribunal process, further to recommendations in 2018[12] by the Treasury Select Committee and the All-Party Parliamentary Group on Fair Business Banking.[13] This Tribunal would be for consumers and small businesses to make claims and challenge the proper interpretation of the regulators' rules under section 138D of FSMA or to seek final determination of an interim-binding decision of the new Financial Adjudication Service.[14]

26. The First Tier Tribunal should issue reasoned decisions. The resulting precedent would provide much-needed legal certainty over the meaning and application of Principles when applied as aids to the interpretation of specific rules, or on a standalone basis (if they are so used).

27. The Upper Tribunal will have appellate jurisdiction over judgments of the new First Tier Tribunal, offering firms a clear appellate route through the Courts to raise customer-firm disputes. In order to manage the caseload of the Upper Tribunal, applications for permission to appeal should be declined where the Upper Tribunal considers that an appeal would be vexatious or unnecessary.

Part XVI FSMA: Reform of the FOS

28. This part improves and adapts the processes used by the FOS (to be known as the FAS going forward), so that it can be relied upon as an acceptable form of alternative dispute resolution for both consumers and small enterprises. FAS will apply a process of adjudication, which is a form of early expert determination (used by the construction industry since 1996) which combines speed and credibility in the resolution of disputes.

29. The process would involve a relevant market expert (drawn, e.g., from the ranks of the Tribunal panel members) with a tight timeline for issuing a reasoned decision (e.g., 56 days, with the possibility for extension). The complaint would be determined impartially through the application of legislation, (for smaller claims) regulation and common law, and the reasoned decision would apply these to the facts so far as is necessary. Similarly to the FOS, as part of its determination the FAS would be able to make a money award as compensation for loss or damage suffered by the complainant. This compensation would reflect the applicable law and rules—including fairness obligations—rather than simply deciding what is "a fair way to resolve the dispute."[15]

30. Either party should have the right to bring its case to the First Tier Tribunal for final determination. Where a respondent chooses this option, they would be obliged to cover the complainant's costs and meet other conditions of the Tribunal. However, it is anticipated that in practice most parties

---

12 House of Commons Treasury Committee, *SME Finance* (HS 805, 28 October 2018).

13 Kevin Hollinrake MP (Co-Chair of the All-Party Parliamentary Group on Fair Business Banking) *Fair Business Banking for All: How to improve access to justice for businesses in financial services disputes* (10 July 2018). The report was "unreservedly commended" by former Master of the Rolls, Lord Dyson.

14 Giving a ruling about the interpretation of one of the regulators' rules could be achieved at present by applying to the High Court for a "Part 8 Claim," which is expressly provided for in the White Book; but we are not aware that this process has been used in this context.

15 Currently, where a complaint is referred to the FOS on or after 1 April 2022, the maximum money award which the FOS may make for a complaint concerning an act or omission by a firm on or after 1 April 2019 is £375,000. This maximum amount varies according to when the complaint was referred and when the relevant act or omission took place. It is intended that the current maximum award (and process for adjusting this) would be maintained when the FAS is introduced. Beyond the money award, as with the FOS, it is intended that the FAS may make awards for costs and interest, and recommend that the respondent pays a larger amount than the maximum money award to the complainant.

would ordinarily accept the FAS's decision provided that the credibility of the decision-maker and the quality of reasoning in the decision are maintained. This adjustment would address any concerns that the First Tier Tribunal would not have the capacity and speed to deal with the caseload in some circumstances.

Sections 84, 87 and 87A FSA 2012: Bolster the powers of the Financial Regulators Complaints Commissioner (FRCC)

31. This section amends the FSA 2012 so that FRCC decisions are legally binding on the regulators (other than as to damages payable by the regulators, which will remain a recommendation and *ex gratia*, in line with the principle that regulators are exempt from liability in damages). This deals with the presently unsustainable situation where all FRCC decisions, even findings that the regulators have acted unlawfully, are non-binding recommendations which can be (and, at least sometimes, are) ignored by the regulators. Where the FRCC has gone through a thorough process and found serious error, there needs to be some form of binding redress. Limits on financial awards are expressly excluded here, to prevent the regulators from arbitrarily restricting their compensation liabilities, as the FCA was found to have done in its June 2020 remedies statement. Financial awards would remain *ex gratia* and therefore only payable at the discretion of the regulators. Regulators will be required to take certain matters into account in determining the amount of compensation payable, including whether the regulator was the primary or secondary cause of loss (which consideration may reduce, but not absolve, a regulator from liability) and the fact that compensation payments must ultimately be funded by levies on industry.

32. The scope for the FRCC is also clarified so as expressly to cover firm-regulator disputes and senior manager-regulator disputes, which are likely already to be in scope but are not currently a focus. The remit of the complaints scheme would be expanded so that complaints may be made in instances where the regulators have failed to exercise their "general functions" (e.g., their powers to make rules and technical standards and to issue guidance etc.) in accordance with their statutory objectives. This enshrines in statute the FRCC's ability to make such findings, as it did when finding the FCA had incorrectly applied its objectives to determine the parameters of compensation for victims of the London Capital & Finance scandal. The time limit for launching such a complaint would begin on the date the relevant rule or other material is published. Because the FRCC's decisions would be binding, the decisions would become reviewable in the Tribunal at the application of the FCA or PRA or affected firms or customers. There will be no cost risk to a complainant in cases where the regulator makes the referral, to protect complainants from the risk of financial loss where a regulator appeals a successful complaint. The grounds for referral would be limited to cases where the decision is obviously wrong or of particular importance for the market.

Section 66A and 66B FSMA: Reform to the senior managers regime

33. This section clarifies the standards for senior managers, so that the focus is principally on wrongdoing by the firm and those responsible for that. The test for a senior manager is set at a level that requires them to have contributed to any contravention of the relevant requirement by their firm. A senior manager is also able to obtain a declaration from the Upper Tribunal that they acted reasonably and in good faith, which protects against liability for misconduct. These changes have been made in order to avoid lengthy rulebooks and litigation over senior managers.

Section 404D: Application to the Upper Tribunal to quash PRA and FCA rules

34. This section provides that authorised persons may make applications to the Upper Tribunal for a review of rules made by the PRA or the FCA. The Tribunal should determine the application by applying the principles applicable for judicial review, and may make an order quashing those rules.

This provision has been incorporated within existing provisions and processes for applications to override rules relating to consumer redress.