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The proposed restructuring of the UK financial regulatory framework

The UK Government has published a white paper and draft bill setting out further details of its proposals for a new structure of financial regulation. The FSA, currently the sole regulator of the financial sector, will be replaced with two bodies: (i) a prudential regulator, to be known as the Prudential Regulation Authority and (ii) a conduct of business regulator, to be known as the Financial Conduct Authority. In addition, macro-prudential or systemic risk regulation will fall to a new Financial Policy Committee of the Bank of England. The financial services industry is likely to face more intrusive and judgment-based regulation once the new structure is adopted.

Introduction

The UK Government will be pushing ahead with its plans to reform the financial regulatory system in the United Kingdom in line with its initial proposals.[1] In addition to the white paper, the regulatory approaches to be adopted by the Prudential Regulation Authority (the "**PRA**") and Financial Conduct Authority (the "**FCA**") have been further detailed in two subsequent papers.[2]

As originally proposed, the current functions of the Financial Services Authority ("**FSA**") will be re-assigned between the two new regulatory bodies and the Bank of England ("**BoE**") as follows:

- the PRA will be a subsidiary of the BoE carrying out 'micro-prudential', firm-specific regulation of regulatory capital and related matters;
- the FCA, effectively the successor to most current FSA functions, will be responsible for conduct of business regulation of all firms within the financial services sector as a whole and the prudential regulation of firms outside the remit of the PRA. The FCA will be the same legal entity as the FSA, so in reality this is a change of name and functions of the current regulator, with a narrowing of its focus; and

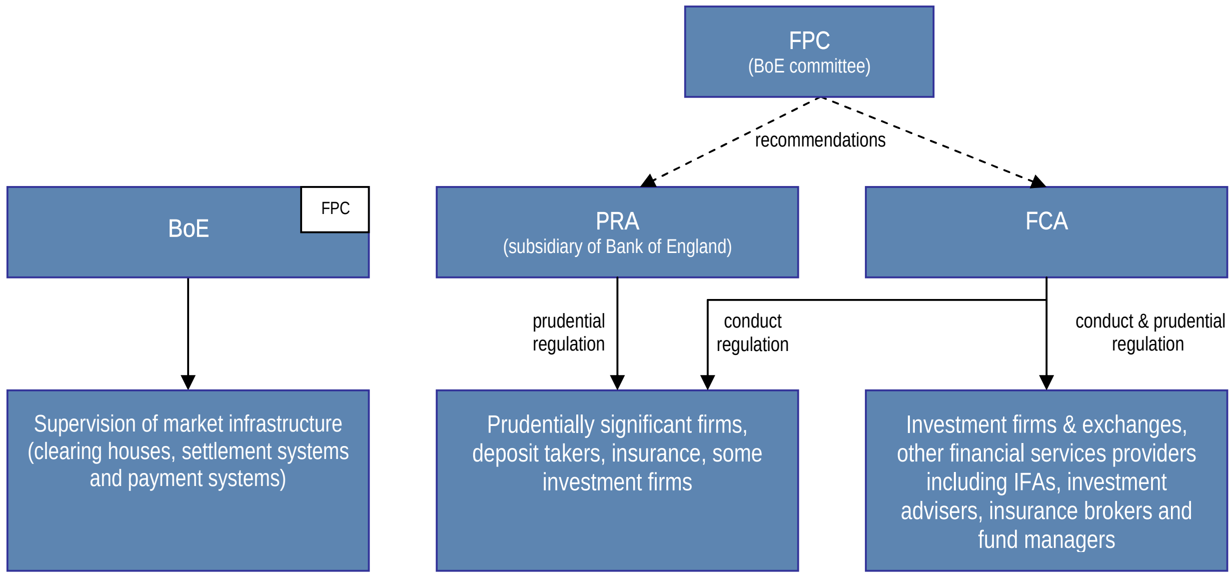
[1] See our client note of 5 April 2011 entitled "Reforming the Framework for Financial Regulation in the UK", available at: http://www.shearman.com/reforming-the-framework-for-financial-regulation-in-the-uk-04-05-2011/.

[2] "Our approach to banking supervision", published by the BoE and FSA jointly (the "**PRA Approach Paper**") and "Financial Conduct Authority: Approach to Regulation", published by the FSA (the "**FCA Approach Paper**").

- the BoE will be responsible for the supervision of market infrastructure, taking over from the FSA as the regulator for clearing houses as well as regulating settlement systems and payment systems.

In addition, a new Financial Policy Committee (the "**FPC**") will be established within the BoE, responsible for addressing systemic risk and the macro-prudential supervision of the financial sector as a whole. An interim FPC was established in February 2011.

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



The reforms will be implemented by amendments to the Financial Services and Markets Act 2000 ("**FSMA**"), as opposed to an entirely new governing act.

During the course of 2011 the FSA introduced a shadow internal structure allocating FSA staff and responsibilities in anticipation of the creation of the PRA and the FCA. The FSA is training staff, designing and piloting new regulatory processes and carrying out internal reorganisations with a view to ensuring it is ready for the transfer and to establish a structure that more closely resembles the FSA's successor bodies.

Macro-prudential or systemic risk regulation: the FPC

Objective and Scope:

The FPC will be responsible for identifying, monitoring and taking action to remove or reduce systemic risks at a macro level, including systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector and unsustainable levels of leverage, debt or credit growth. In order to balance systemic risk regulation with the imperative of fostering economic growth, the FPC will not be required or authorised to exercise its functions in a way that would undermine economic growth in the medium or long term.

The remit of the FPC will be renewed by the Treasury annually and the FPC will be required to respond to the Treasury's recommendations, setting out the extent to which the FPC agrees with the remit and what action it intends to take in response to the recommendations.

Functions:

The FPC will have access to the following 'levers' to achieve the financial stability objective:

- public pronouncements and warnings (e.g. to publicise a concerning trend);
- influencing macro-prudential policy in Europe and internationally;
- making recommendations to bodies other than the PRA and FCA (such as HM Treasury and the BoE);
- making recommendations to the PRA and FCA, backed up by a comply-or-explain process; and
- issuing directions to the PRA and the FCA pursuant to powers to be granted by (and defined in) secondary legislation.

The 'interim' FPC, which held its first meeting on 16 June, has the responsibility of undertaking an analysis of potential macro prudential tools that could be used by the FPC and to report to the Treasury with its recommendations for its permanent toolkit.

Micro-prudential regulation: the PRA

Objective:

The PRA's general objective will be "to promote the safety and soundness of PRA-authorised persons". That objective is to be met primarily by:

- seeking to ensure that the business of PRA-authorised persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- seeking to minimise any adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.

The PRA also has an "insurance objective", namely contributing to the securing of an appropriate degree of protection for those who are or may become policyholders (including an appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under with-profits policies where effecting or carrying out with-profits policies is a PRA-regulated activity).

The PRA will aim to reduce the likelihood of a firm failing, but where a firm does fail, its role will be to ensure that it does so "in an orderly manner" and without disruption to the financial system. The PRA is not under any duty to ensure that no PRA-authorised person fails. It is therefore a disorderly failure of the kind that occurred with the insolvency of Lehman Brothers that the PRA will aim to prevent.

Scope:

The PRA will be the body responsible for authorising deposit-taking banks, insurers and certain large investment firms. The PRA will have the power to designate firms for prudential supervision (and hence authorisation) by it, subject to a range of procedural safeguards. The PRA Approach Paper gives some indication of the types of firms which are likely to fall within the PRA's jurisdiction. It states that, in addition to deposit-takers and insurers, the PRA will be responsible for the supervision of a number of investment firms that could present significant risks either to the stability of the financial system or to one or more PRA-supervised entities within the firm's group. The PRA will need to develop additional criteria for designation and will consult on its proposed policies in this area in due course. The PRA Approach Paper sets out the following examples of likely criteria:

- the size of a firm;
- the substitutability of its services;
- the complexity of its activities; and
- its interconnectedness with the financial system and any PRA-authorised entities within its group.

It is likely that many of the global investment banks operating in the United Kingdom would come under PRA supervision.

Supervisory Approach:

Following a "judgment-led" or "purposive" supervisory approach, the PRA will try to focus on the "big picture", locating the key risks to the stability of the financial system and acting in a forward-looking manner. Where potential threats to the soundness of institutions are identified, the PRA will take supervisory action at an early stage to reduce the probability of a disorderly failure. Its preference will be to use its statutory powers to secure *ex ante* remedial action, as opposed to waiting for firms to violate rules and then punishing them.

Tribunal Review of PRA Decisions:

The Government had previously mooted restricting Tribunal review of PRA decisions to certain limited grounds (similar to the ones that can be raised in judicial review) rather than the full merits review applicable for FSA decisions. The Government has decided instead to limit the course of action available to the Tribunal in the event it decides not to uphold a decision. The Tribunal will not be able to substitute its opinion for that of the regulator, but it will instead have to remit the matter back to the regulator to take a fresh decision.[3]

Conduct of business and markets regulation: the FCA

Objective:

The FCA's strategic objective will be "to protect and enhance confidence in the UK's financial system". Its operational objectives will be threefold: (i) securing an appropriate degree of protection for consumers, (ii) protecting and enhancing the integrity of the UK financial system, and (iii) promoting efficiency and choice in the market for financial services.

The FCA will be responsible for conduct of business regulation of all UK financial institutions, including those authorised by the PRA. It will also undertake prudential supervision of firms not authorised by the PRA. Firms subject to authorisation by the FCA will typically be investment managers, investment advisors, brokers, providers of market trading infrastructure, mortgage brokers and insurance brokers.

Competition Duty:

The FCA will have a duty to discharge its general functions in a way which promotes competition, unless this would be incompatible with its strategic and operational objectives. The FCA will put in place a business and markets analysis

[3] This will not apply to disciplinary matters and those involving specific third party rights.

team which will, among other things, identify the features of industry economics (such as very high returns on particular products) which may indicate or create incentives for actions detrimental to consumer interests.

Although the FCA is not intended to be an economic regulator, the FCA Approach Paper states that the FCA will nevertheless be interested in prices because "prices and margins can be key indicators of whether a market is competitive". Where competition is impaired, the FCA may engage in price intervention to protect consumers.

The Government has also consulted on the merits of transferring responsibility for the regulation of consumer credit from the Office of Fair Trading (the "**OFT**") to the FCA. It will announce its decision later in the year. In a separate initiative, it is proposed that the competition functions of the OFT and of the Competition Commission be merged into a new single competition authority, the Competition and Markets Authority ("**CMA**").

Product Intervention Power:

The FCA will be granted powers to prohibit specific financial products or prevent product launches, subject to safeguards to prevent excessive use of such powers. The FCA will not be able to renew any temporary product intervention rules when they expire, so that if the FCA wishes to extend such rules beyond a 12-month period it must do so following the general rule-making procedure. Furthermore, the FCA may not use its product intervention powers to advance the market integrity objective, but only to advance its consumer protection, efficiency and operational objectives.

New Financial Promotions Power:

The FCA will have the power to ban misleading financial promotions. The FCA must publicise any action taken to ban such promotions, although it may publish only such information as it considers appropriate. The FCA will be required to notify relevant firms of any proposal to impose a ban and allow them to make representations. It should be noted that the Advertising Standards Authority also has the power to investigate financial advertising on television and radio, although it may not investigate product-related claims in non-broadcast advertising.

Early Publication of Disciplinary Action:

The Government proposes to give regulators the power — but not the duty — to disclose the fact that a warning notice in relation to proposed disciplinary action has been issued. The regulators will be required to consult the affected firm before publicising the issue of a warning notice. Furthermore, a regulator may not publicise a warning notice if this would be unfair to the affected firm.

Wholesale and Markets Regulation:

Recognised investment exchanges[4] ("**RIEs**") will be regulated by the FCA, whilst recognised clearing houses ("**RCHs**") will be regulated by the BoE. The FCA will have additional powers in relation to RIEs which go beyond those powers currently held by the FSA. These will include powers to:

- impose financial penalties or to issue public censures through a warning notice process in relation to contraventions of regulatory requirements by RIEs; and
- require the appointment of a skilled person to prepare a report on any matter in relation to which the FCA could require an RIE to provide information.

[4] Which, if the requirements outlined in the FSMA are met, can include a recognised overseas investment exchange.

The FCA will also become the listing authority for the purposes of the regime for listed securities in Part 6 of the FSMA. The draft bill includes the following new FCA powers in relation to the listing regime:

- to discontinue or suspend a listing at the request of an issuer, without following the statutory notice procedure;
- extended powers to impose sanctions on sponsors for certain breaches (subject to the normal procedural mechanisms in the FSMA);
- to require the appointment of a skilled person to prepare a report in respect of any matter reasonably required in connection with the exercise by the FCA of its functions; and
- to make and enforce requirements on persons approved as primary information providers.

As part of the FCA, the UKLA will be subject to the FCA's general strategic and operational objectives to:

- protect and enhance confidence in the UK financial system;
- secure protection for consumers;
- promote efficiency and choice in the market; and
- protect and enhance the integrity of the UK financial system.

Supervision of market infrastructure: the BoE

The paper confirms that the regulation of systemically important infrastructure will be transferred to the BoE, which will take over responsibility for regulating settlement systems and RCHs, including recognised overseas clearing houses. These roles will sit alongside its current responsibility for the regulation of recognised payments systems under the Banking Act 2009.

While RCHs will continue to be regulated under FSMA, the draft bill does propose a number of technical changes to the current legislation, which include allowing the BoE:

- to appoint persons to carry out general investigations into the business or ownership of an RCH (a power which is currently only exercisable in relation to recognised investment exchanges);
- to require the appointment of a skilled person to report on any matter in relation to which the BoE could require an RCH to provide information;
- to apply the warning notice disciplinary regime; and
- to impose financial penalties or issue a public censure in relation to contraventions of regulatory requirements by RCHs.

The draft bill also proposes to grant additional powers to the BoE in relation to the supervision of settlement systems and payment systems. The draft bill contains provisions dealing with co-ordination of crisis management, including a duty on the Governor of the BoE to inform the Chancellor of the Exchequer of possible calls on public funds, and a duty on the BoE and the Treasury to prepare a Memorandum of Understanding on how they will co-ordinate and manage a crisis situation. It is also proposed that the existing exemption from the Competition Act 1998 for recognised investment exchanges and clearing houses will be removed, although no clear rationale has been presented for this.

Specific Regulatory Processes

Authorisation and EU Passports:

It is now proposed that one of the PRA or FCA will have responsibility for processing applications for regulatory authorisation and will seek the consent or comment of the other where appropriate. Under this proposal, the authority that would be responsible for the authorisation of a firm will manage the application process and ultimately grant permission. For dual-regulated firms (i.e. firms subject to authorisation by the PRA but also subject to conduct of business regulation by the FCA), the PRA will be required to gain the consent of the FCA prior to granting permission, but the Government expects that the FCA will be fully involved in the authorisation process in these instances.

The authority responsible for authorising a firm will also be responsible for issuing and receiving all relevant notices relating to European passports.

Approved Persons:

The Government had originally proposed to grant the PRA the responsibility for designating Significant Influence Functions ("**SIFs**") as solely 'prudential' or 'conduct' functions. In response to comments received during the consultation, there is an alternative proposal in the draft bill:

- for dual regulated firms, the PRA should have primary responsibility for designating SIFs and will have responsibility for approving applicants. The FCA is allowed to designate additional SIFs that will be subject to FCA approval;
- the FCA will be able to make and enforce its own codes on all approved persons (whether approved by the FCA or the PRA), and will ultimately be able to remove approval from individuals for egregious conduct or consumer protection breaches; and
- the authorities will be required to consult each other to minimise the risk that the codes that they make overlap or duplicate.

Conclusion and next steps

Although many of the issues raised by the Government in the previous consultations have been addressed, several proposals are likely to remain problematic for the financial services sector. In particular, the requirement for the PRA to seek the FCA's consent to a regulatory authorisation application of a dual-regulated firm is likely to add to the administrative burden of obtaining regulatory approvals. It is hoped that these additional processes will not cause delays to authorisation applications. The wide-ranging powers of intervention granted to the FCA in relation to pricing may prove counterproductive if the result is that firms simply withdraw products from the market or refuse to deal with certain clients. Giving the FCA the power to intervene in pricing decisions is tantamount to making it an economic regulator in a sector that is already subject to competition regulation. Finally, many of the new powers over recognised investment exchanges and clearing houses do not appear to have any obvious rationale or to be based on any prior market or supervisory failure.

The draft bill will now be subject to pre-legislative scrutiny. The deadline for responding to the consultation paper was 8 September 2011. Following pre-legislative scrutiny, the Government will formally introduce a bill in Parliament with the intention of giving effect to the new regulatory architecture by the end of 2012.

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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