

HM Treasury's Consultation Paper on the new UK Financial Regulatory Framework.

Introduction

On Monday 26 July 2010, HM Treasury published its Consultation Paper entitled: "A new approach to financial regulation: judgement, focus and stability" (the "**Consultation Paper**"). In the Consultation Paper, the Government confirmed its intention to abolish the Financial Services Authority (the "**FSA**") and create a new Financial Policy Committee within the Bank of England (the "**FPC**") responsible for "macro-prudential regulation and financial stability", alongside two new regulators: (a) a Prudential Regulatory Authority ("**PRA**") with responsibility for prudential regulation of deposit takers, insurers, principal dealers, and (b) a consumer protection and market authority ("**CPMA**"), which will be responsible for conduct of business regulation of all firms and prudential regulation of non-PRA Firms. Each of the PRA and the CPMA will have their own enforcement and supervision powers. The Bank of England will have responsibility for supervising and regulating clearing houses and settlement systems ("**CCPs**").

The Consultation Paper seeks views on the scope, objectives, powers and governance arrangements for these bodies, and on the general principles that will govern their cooperation, coordination and consultation efforts. The Government intends for the new financial regulatory structure to be in place within two years (i.e. by 2012¹), and for the Bank of England and FSA to 'shadow' the new structure in the meantime.

Executive Summary

The Consultation at a glance:

- > The FPC will have ultimate responsibility for macro-prudential regulation and financial stability. It will have the power to give directions to the PRA and the CPMA to implement the FPC's decisions. The FPC will work with the G20 Financial Stability Board and the European Systemic Risk Board on systemic issues.
- > The PRA will operate as the prudential regulator for deposits-takers, insurers, and firms dealing as principal (the "**PRA Firms**").

¹ Speech by the Financial Secretary to the Treasury, Mark Hoban, MP, at the London Stock Exchange on 26 July 2010.

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- > The CPMA will act as the prudential regulator for non-PRA Firms (e.g. investment advisers, investment managers, etc.) and as the conduct regulator for all firms, including PRA Firms, in relation to both retail and wholesale business. It will also have the responsibility for regulating the exchanges, trading platforms and the markets, e.g. through the market abuse regime. Responsibility for consumer credit may be transferred from the OFT to the CPMA - this will be subject to a separate consultation.
- > The Bank of England will be given responsibility for regulating and supervising CCPs.
- > The UKLA will either be merged with the Financial Reporting Council (to link listing, disclosure and governance) or be part of the Markets Division of the CPMA (to link listing, disclosure and market supervision/conduct). Views are also sought on moving towards establishing a companies regulator which would be responsible for regulating primary market activity, corporate governance, corporate information and stewardship.
- > The Consultation Paper also provides an outline of how the new regulatory structure should react to a financial crisis and details further work that the Government intends to undertake in this area.
- > The proposed white collar crime agency is not discussed in this Consultation Paper - it will be subject to a separate consultation.

The Government's proposals are a positive step forward in seeking to address what, in retrospect, was a glaring gap in the regulatory framework, i.e., that there was no-one to take responsibility for the oversight of macro-economic risk in the financial markets. On the other hand, the obvious comment about the proposed new regulatory structure is that it will require a very high degree of co-operation and co-ordination between the different regulatory bodies to avoid both "overlap" and "under-lap". In addition, we note that one of the drivers to forming the CPMA was to ensure that there was a better, more concentrated focus on consumer protection (the feeling being that this had been diluted at the FSA, due to it being a monolithic regulator). It remains to be seen whether the CPMA will have that focus either, given the different roles proposed for it. It is to be hoped that these issues will be considered as we move through the consultation process towards a reformed regime.

The consultation will close on 18 October 2010. However, the Government will present more detailed proposals - including draft legislation - for further consultation in early 2011.

We are in the process of finalising our response to the Consultation Paper.

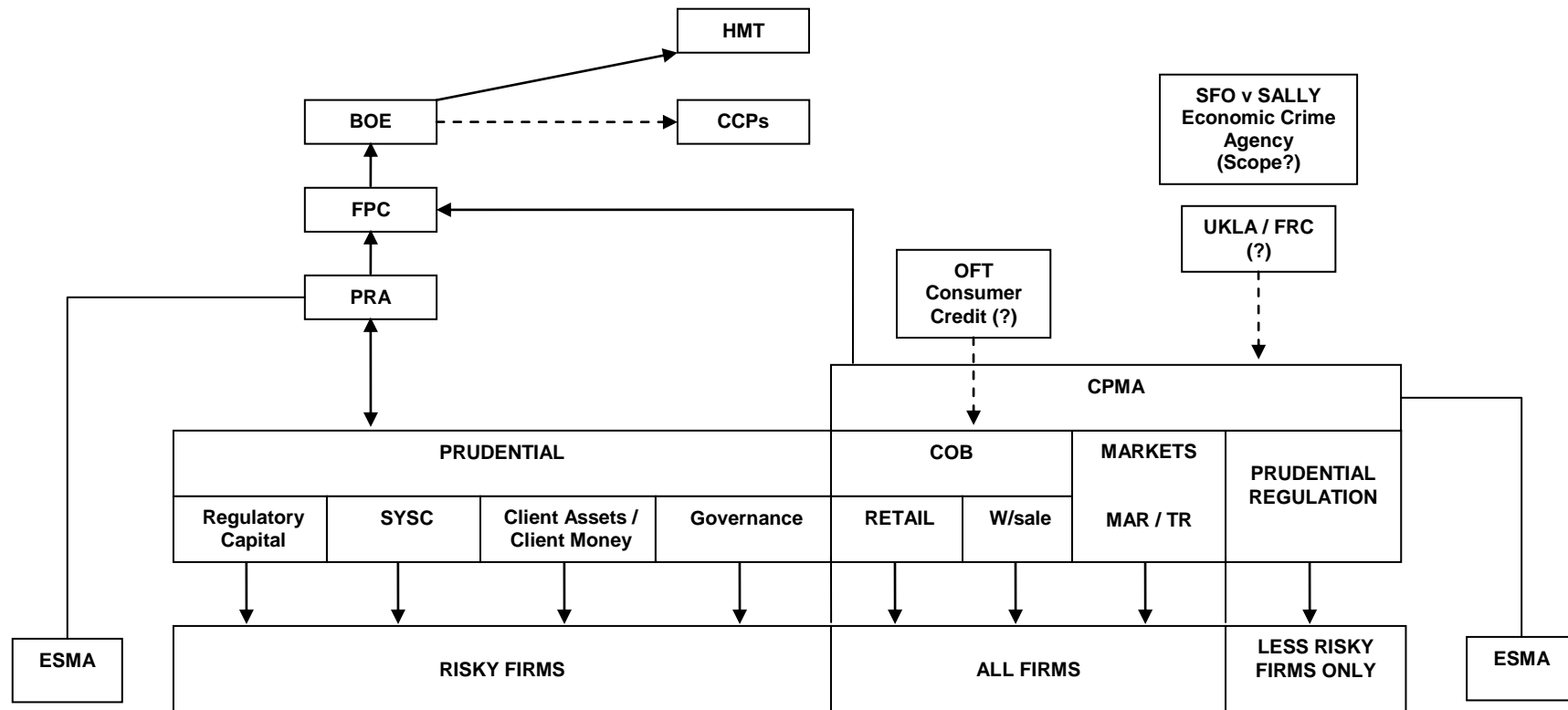
An overview of the key topics in the consultation is set out below.

The Structure

The Government's rationale for reforming the UK financial regulatory structure is to tackle the perceived weaknesses and inadequacies of the existing tripartite system: i.e., the fragmented structure, with responsibilities, powers and capabilities split amongst the regulatory bodies in an ill-defined way.

The Government will address this by clearly setting out the precise scope of the responsibilities of the FPC, PRA, CPMA, and the Bank of England, and the manner in which they will operate, and coordinate with one another, both during "peacetime" and in a crisis. In summary:

New Financial Regulatory Structure



FPC

Introduction

The FPC will have primary statutory responsibility for macro-prudential regulation and financial stability by identifying cyclical imbalances, emerging risks and vulnerabilities in the financial system and taking appropriate action as necessary. This may include recommending action to be taken by the PRA, the CPMA, and/or the Bank of England. The PRA, and where necessary, the CPMA will also be obliged to implement the FPC's decisions on the use of its macro-prudential tools by applying them across all relevant firms.

The precise scope of the FPC's macro-prudential tools are under consideration but include: (a) counter-cyclical capital requirements, (b) leverage limits, (c) variable risk weights, and (d) collateral requirements. The necessary interchange of information between the FPC and the PRA and CPMA will take place principally within the FPC meetings.

The PRA and CPMA will provide information to other FPC members prior to their regular meetings on the most significant system wide and firm specific risks being tackled by the PRA and the most significant prevailing retail and market conduct risks being tackled by the CPMA.

The FPC will have responsibility for monitoring and determining whether the split between the responsibility of the CPMA and the PRA is appropriate. However, there are no details in the Consultation Paper on how this will actually work in practice.

Membership, Functions and Macroeconomic Tools

A list of its membership, functions and macroeconomic tools is set out below.

Membership, Functions and Macro-Prudential Tools

Membership

The FPC will be established as a committee of the Court of Directors of the Bank of England. It will have a total membership of 12.

It will be chaired by the Governor of the Bank of England. Other members include:

- > The existing Deputy Governors for monetary policy and financial stability;
- > Hector Sants (Deputy Governor and CEO of the PRA);
- > two Bank executives (responsible for financial stability and markets);
- > the chief executive of the CPMA;
- > four external members will be appointed by HM Treasury;
- > one non-voting Treasury representative.

Functions

Monitoring, to identify risks to financial stability including:

- > monitoring activities of PRA and CPMA for financial stability implications that derive from their actions
- > monitoring the regulatory perimeter, to understand systemic implications of activities outside regulated area.

Action, to address vulnerabilities, emerging risk and imbalances identified, including:

- > deployment of macro-prudential tools;
- > directing the PRA and CPMA on deployment of their regulatory tools, if needed to protect financial stability;
- > making recommendations in relation to other Bank of England activities (e.g. liquidity provision);
- > recommending changes to PRA's and CPMA's regulatory perimeter to HMT or to the FPC's macro-regulatory toolkit.

Communicating to parliament and the public on their analysis any and action taken, including:

- > six-monthly public reports summarising systemic risks etc identified by it;
- > publication of minutes of its meetings, with arguments for and against decisions taken, within six weeks of meeting.

Meetings: at least four times a year.

Macro-prudential tools

Countercyclical capital requirements

Variable risk weights

Leverage limits

Forward-looking loss provisioning

Collateral requirements

Quantitative credit controls and reserve requirements.

Provision to be made in secondary legislation.

Where necessary the FPC can direct the PRA or the CPMA to apply the tools in accordance with its decisions.

The PRA

Introduction

The scope of the PRA's responsibilities are more extensive than previously anticipated. The PRA will have primary responsibility for the "micro-prudential regulation" (i.e. prudential regulations) of firms who are subject to "significant prudential regulation" ("**PRA Firms**"). The Government expects the PRA to regulate: (a) banks and other deposit takers (including building societies and credit unions); (b) certain broker-dealers (or investment banks) with permission to deal as principal; and (c) insurers (including friendly societies). However, the scope may change with the potential inclusion of credit rating agencies and those operating within the "shadow banking sector". The PRA will be responsible for reviewing and making recommendation on the scope of firms regulated by the PRA to HM Treasury.

We expect that the PRA's prudential regulatory function will be focused on the following key areas: (a) regulatory capital, (b) systems and controls, (c) client assets/client money, and (d) governance. All conduct regulations will be dealt with by the CPMA.

In addition, under the Government's proposed "crisis management proposals", the PRA will have responsibility for making rules and approving the recovery and resolution plans of financial institutions, and triggering the special resolution regime in relation to failed firms, the PRA will be expected to build on the FSA's current initiatives in this area, including, on "living wills".

The PRA will represent the UK on the new European supervisory authorities for the banking sector and the insurance and occupational pensions sectors:

- > the European Banking Authority (the "**EBA**"); and
- > the European Insurance and Occupational Pensions Authority (the "**EIOPA**").

Membership, PRA Firms and Functions

A list of its membership and functions is set out below.

Membership and Functions

Membership

The PRA will be an independent subsidiary of the Bank of England. However, the Bank of England will not have formal power to direct the PRA to take firm-specific action.

The Board will comprise of:

- > The Governor of the Bank of England (Chair);
- > The Deputy Governor as CEO (Hector Sants);
- > The CEO of the CPMA (ex-officio);
- > the deputy Governor of financial stability (ex-officio); and
- > a majority of non-executive members appointed by HMT.

Significant decisions on prudential regulation will be taken by the executive only. Non-executives will provide market-informed advice.

Functions

Key functions will include:

- > Assessing the financial/prudential soundness of PRA Firms and taking appropriate action;
- > Making prudential rules for PRA Firms;
- > Authorisation of PRA Firms;
- > Approval of individuals to perform certain controlled functions for PRA Firms. Conduct based functions approved by CPMA. Supervision of PRA Firms, and enforcement for non-compliance with its rules by PRA Firms;
- > Approving recovery and resolution plans for failed institutions;
- > Triggering the special resolution regime in relation to failed firms, raising funds for the PRA.

A "credible and intrusive" approach required.

Judgement-led, based on understanding business models and strategies, rather than "tick box" or rules-based regulation.

The CPMA

Introduction

The CPMA's primary objective will be to ensure confidence in financial services and markets, with a particular focus on protecting consumers and ensuring market integrity. Its operations will be supported by a "credible enforcement function". It will regulate the conduct of all firms, including PRA Firms, in their dealing with retail customers and on the wholesale financial markets. It will also regulate firms providing market services (i.e. investment exchanges and MTFs) and market conduct more generally (including the civil market abuse regime). It is unclear at this stage whether responsibility for the functions of the UKLA or enforcing the criminal insider dealing regime will reside within the CPMA.

In recognition of the key differences between retail financial services conduct and wholesale financial markets conduct issues, responsibility for all market conduct regulation will be located within an operationally distinct division of the CPMA, which will also have a separate enforcement function.

A separate consultation paper will be published in the autumn of 2010, which will consider amongst other things, whether responsibility for the UK consumer credit regime should be transferred from the OFT to the CPMA.

The markets division will represent the UK in the European Securities and Markets Authority ("**ESMA**").

Membership, and Functions

A list of its membership and functions is set out below.

Membership and Functions

Membership

CPMA will be a company limited by guarantee, financed by the industry. The board will be appointed by HMT. It will comprise of:

- > the CEO of the CPMA (Chair);
- > the CEO of PRA

HM Treasury and BIS will jointly appoint a proportionate number of non-executives to the board to ensure that appropriate expertise in these areas is available to the board.

The Board will have rule making powers, but significant supervisory and regulatory decisions relating to individual firms will be reserved to an executive committee of the board, which will include only non-executives who have no conflict of interest.

The power to make rules and the power to raise levies from industry to fund the CPMA's work will be reserved to the CPMA's board.

CPMA Markets Divisions Functions

The Government proposes to make the CPMA markets division responsible for regulating the conduct of participants in:

- > organised financial markets whose facilities are provided by investment exchanges and MTFs;
- > over-the-counter (OTC) financial markets in which off-exchange dealings take place bilaterally between financial institutions and other large wholesale market participants; and
- > in relation (in principle) to all financial instruments and other derivative contracts traded on those markets.

In addition it will regulate the civil market abuse regime.

Functions

The CPMA will have responsibility for:

- > regulating of regulating the conduct of business of all firms, including PRA Firms in both the retail and wholesale markets;
- > authorising and supervising all non-PRA Firms; and the prudential supervisory framework for non-PRA Firms;
- > granting permissions for all regulated activities for non-PRA firms;
- > supervising, and where necessary, taking enforcement action for non-compliance with its rules and policies;
- > approving individuals to perform conduct-related "controlled functions" (undefined) for PRA Firms;
- > approving all "controlled functions" where firms are solely regulated by the CPMA;
- > enforcing the Unfair Terms in Consumer Contracts Regulations in respect to financial services consumer contracts;
- > raising of levies to fund the activities of the CPMA and potentially the PRA;
- > exercising the existing FSA responsibilities for the Financial Ombudsman Service, the Financial Services Compensation Scheme, and the Consumer Financial Education Body.

A "tougher, more proactive and more focused" approach required. More "interventionist and pre-emptive" approach to retail conduct regulation, building on FSA's Retail Conduct of Business Strategy, Retail Distribution Review and Mortgage Market Review.

Bank of England

Introduction

The Government is proposing to transfer responsibility for regulating and supervising CCPs to the Bank of England alongside its payment systems oversight. The Government will consider whether there is scope for rationalising the two regime in FSMA under which trading platforms and clearing houses are regulated. It expects that the regimes for the approval of operators of relevant settlement systems under the Uncertified Securities Regulations 2001 and for designating systems for the purposes of the Financial Markets and Insolvency (settlement Finality) Regulations 1999 will continue largely unchanged.

The use of CCPs is set to rise following the passing of the Dodd-Frank law in the US last week that requires a large number of OTC derivatives to be cleared through clearing houses. The European Central Bank is of the view that the role of central banks should be explicitly reflected and clearly set out when it comes to deciding which OTC derivatives should be eligible for clearing and that central banks should be involved both in the authorisation and ongoing supervision and oversight of CCPs². The European Commission is currently in the process of finalising new rules on the regulation and supervision of clearing houses following its recent consultation. New draft rules are expected to be published in September 2010.

Co-ordination and Co-operation

The Government expects that the supervision of "market infrastructure" will follow the same general principles of cooperation, coordination and consultation as for any other type of regulated entity. So, the Bank of England is expected to cooperate closely with the CPMA, reflecting the CPMA's responsibilities for on-exchange and OTC financial markets; and representing the UK in ESMA. In relation to individual firms subject to regulation by both the Bank of England and the CPMA (for example, where an investment exchange also operates its own in-house CCP) such a firm will be authorised and supervised by the Bank of England for clearing and settlement but it will be subject to conduct of business regulation and supervision by the CPMA in respect of non-financial stability matters.

UKLA and Companies Regulator

UKLA

The Government is considering whether to merge the UKLA with the Financial Reporting Council or whether it should be transferred to the CPMA markets division. The Government believes that this would have the benefit of bringing the UKLA's regulation of primary market activity alongside FRC functions relating to company reporting, audit and corporate governance.

² Financial Times, 26 July 2010, On-line Article by Jeremy Grant.

Companies Regulator

The Government believes that there is a strong case for a powerful companies regulator established with responsibilities for regulating corporate governance, corporate information and its disclosure, and the stewardship of companies by institutional shareholders. The Department of Business Innovation and Skills will bring forward detailed proposals for consultation in due course.

The Government is also seeking views on whether there are other aspects of financial market regulation in which the links with companies law are sufficiently close to warrant consideration of transferring them to the potential new companies regulator.

Crisis Management Strategy

The Consultation Paper also provides an outline of how the new regulatory structure should react to a financial crisis and details further work that the Government intends to undertake in this area. The Chancellor is responsible and accountable to Parliament for the authorities' crisis management strategy, and will ultimately control and take decisions on whether to use public funds to assist financial institutions. In this regard, HM Treasury will retain its role within COBRA and other forums and the Chancellor will consult and brief the authorities' as appropriate. The Bank of England will continue to act as lender of the last resort and during a crisis will provide emergency liquidity. The FPC will be responsible for monitoring potential threats to the UK economy, including the emergence of assets bubbles and using its macro-prudential tools to avert any crisis. As noted above, the PRA will be responsible for the recovery and resolution regime and triggering the special resolution regime, when necessary. The CPMA will have the power to "own initiate variations of permission" and the Government is considering whether such intervention should be mandatory at a specified threshold and whether any changes to the trigger points for regulatory action in required.

White Collar Crime Agency

The role of the proposed white collar crime agency is not considered in this Consultation Paper. However, the Government indicated that it will consult separately on whether to transfer responsibility for prosecuting criminal offences involving insider dealing, other forms of market abuse and other criminal law breaches which the FSA currently prosecutes to a white collar crime agency. Media reports suggest that Hector Sants, the current chief executive of the FSA and other senior FSA official are opposed to the transfer of responsibility for the prosecution of criminal insider dealing to the proposed new white collar crime agency³. Indeed, Margaret Cole is encouraging FSA regulated firms to support the FSA's lobbying effort in this regard⁴.

³ Financial Times, 25 July 2010.

⁴ Speech by Margaret Cole at the FSA Conference in 22 June 2010.

The Transition

The FSA will retain its current regulatory responsibilities throughout the transition period, however it will move to separate conduct and prudential regulation in shadow form in the first quarter of 2011. Hector Sants will oversee the transition and will become the first new deputy governor and chief executive of the PRA in 2012, supported by Andrew Bailey from the Bank of England as his deputy. As previously announced, a new interim FPC will be established in the autumn of 2010 (on a non-statutory basis) to carry out preparatory work and analysis in advance of the creation of the permanent FPC, and to begin to undertake the permanent body's macro-prudential role (probably limited to its macro-prudential monitoring function).

The Government confirmed that the UK's institutional representation in international forums, including at a European level will not change until the legislation to create the new structure is enacted in 2012. There is some concern, however, that the disruption caused by implementing this new structure could result in, for example, the FSA inevitably taking its eye off the ball on any new or existing European Union initiatives at a critical stage, to the detriment of the UK financial services sector.

Issues

- > The HM Treasury Paper is presented as a Consultation Paper, yet the FSA will move to separate conduct and prudential regulation in shadow form in the first quarter of 2011, which suggests that the Government has already made up its mind on certain key aspects of the new regulatory architecture.
- > Firms will not only have to deal with multiple new regulators at a UK level but at a European level too. This will require firms to build and develop relationships with a new team of supervisors, who may be unfamiliar with their business plan and strategies. Thus it is likely that firms will have to allocate more time, effort and resources to regulatory affairs in the coming months and years.
- > It is clear that a significant degree of cooperation and coordination between the new regulatory bodies will be required, in order to avoid the obvious potential for regulatory overlap or underlap and the unnecessary imposition of additional costs on regulated firms. There are no specific details in the Consultation Paper on how the FPC will deal with "perimeter issues/disputes" between the CPMA and the PRA, however, it is important that the process adopted is sufficiently clear and robust to provide sufficient clarity and certainty for regulated firms.

- > It is likely that the implementation of this new structure will create a degree of upheaval for the regulators and also for regulated firms. It is likely that the firm authorisation and approved person process will continue to be a slow and protracted process. In order to minimise any potential disruption to PRA firms, we would hope that the PRA and CPMA authorisation and approved person processes will be streamlined to ensure that one set of forms can be submitted to one team, possibly at the CPMA - with the CPMA taking responsibility for passing the forms to PRA for review and approval. It would also make more sense for the PRA and the CPMA to conduct joint rather than separate ARROW and supervisory visits.
- > There is a real danger that the disruption caused by implementing the new structure could result in, for example, the FSA inevitably taking its eye off the ball on any new or existing European Union ("EU") initiatives, at a time when the EU is undertaking wide-ranging regulatory change and reform, for example, in relation to the AIFMD, OTC derivatives regulation, as well as the proposed changes to the European financial regulatory structure. It is vital that the FSA continues to engage with industry and ensure that the UK financial services sector is adequately represented at the Global and European level.
- > It would appear that the more intrusive supervisory approach adopted by the FSA as part of its credible deterrence strategy will expand and intensify under the proposed new regulatory structure. However, it is important that the new regulators exercise their powers in a proportionate and predictable manner and actually seek to make regulation more effective as a means to reduce the likelihood of a future financial crisis rather than simply creating unnecessary layers of regulatory complexity, confusion and uncertainty.

Author:

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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