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Progress update - the move to the new UK Financial Regulatory Structure

UK Regulatory Structure

Significant progress has been made in the last few months to bring forward the Government's proposals to radically restructure the UK regulatory structure. Much of this has been "behind the scenes" as the Financial Services Bill (the "**FS Bill**") proceeds through the UK legislative process, and the FSA changed its operational structure on 2 April 2012 by moving to an internal twin peaks model with separate prudential regulation and conduct of business units. However, the FSA published a paper on how the Prudential Regulatory Authority ("**PRA**") will designate certain investment firms for prudential regulation by the PRA rather than the Financial Conduct Authority ("**FCA**"), as well as its recent consultation paper on changes to the FSA handbook that are required to implement the new structure. There have also been a number of HM Treasury and FSA speeches regarding how the new structure may work in practice. According to Lord Turner at the FSA's recent annual public meeting, the legal cutover to the new structure is likely to be in April 2013, a date which is fast approaching given the magnitude of the changes.

This note sets out an update to our previous progress report on the new UK regulatory structure published in February 2012, and includes a summary of the FS Bill's progress through the UK legislative process to date, as well as key messages on the new structure given in the FSA papers on PRA designation and changes to the FSA rulebook, the FSA Business Plan, the FSA/Bank of England paper on the PRA's approach to consultation, and speeches as summarised below.

The new regulatory structure

Legislative progress - the FS Bill's passage through Parliament

Very broadly, the FS Bill, as anticipated, brings forward the Government's core reforms to establish a new "twin peaks" structure, in which prudential and conduct of business regulation will be carried out by two new regulators (namely the PRA and the FCA), and also to establish the Financial Policy Committee ("**FPC**") within the Bank of England as the UK's macro-prudential authority.

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The FS Bill also provides for the transfer of consumer credit regulation from the OFT to the FCA.

The Government has decided to introduce the new legislation by amending the Financial Services and Markets Act 2000 (“**FSMA**”), as this was considered to be the least disruptive route for the market. A consolidated version of FSMA was published in February 2012.

Following completion of a fairly lengthy pre-legislative scrutiny of the FS Bill in the second half of 2011, the Government published the FS Bill with explanatory notes in January 2012, and it had its first reading in Parliament on 26 January 2012. On 25 May 2012, a *revised version* of the FS Bill was published, with revised *explanatory notes*. This version was then introduced to the House of Lords on 23 May 2012. There have also been a number of House of Commons and House of Lords inquiries into the new regulatory structure proposed, as to be expected from what is a major re-write of the cornerstone of financial services regulation in the UK.

Survival of controversial new powers for FSA

Some of the new powers proposed in the FS Bill have been controversial, and are indicative of the political desire to move from lighter touch, principles based regulation to regulation that is more restrictive and heavy handed in nature. Proposed powers in the FS Bill that have attracted comment from the industry include:

- extensive temporary product intervention powers for the FCA, that will permit the FCA to take a range of actions to stop or place conditions on a product being sold to retail, and in particular, concerns that the powers are inconsistent with product intervention powers under proposals to amend the Markets in Financial Instruments Directive (and so will have to be amended to ensure compliance with this directive);
- the power for the PRA/FCA to disclose that a warning notice has been issued in respect of a disciplinary action (currently the FSA may only publish decision notices, which are issued at a later stage in any enforcement proceedings); and
- powers for the FCA in relation to misleading financial promotions (e.g. to give directions to firms and to disclose enforcement action taken).

In addition, curtailing the existing remit of the Financial Services Tribunal to decide on the correct decision and direct the FSA to implement it, have caused concern amongst stakeholders, as well as proposals to amend FSMA so that decision-makers no longer need to be wholly independent. This will open the door to allow a person who is part of the enforcement team at the FSA, and who has been involved in establishing the evidence upon which the decision to issue a supervisory notice is based, to be one of the decision makers.

If implemented, this would in effect undo changes made to the enforcement process in 2005 following criticisms of it made by the Tribunal in a couple of cases (notably Hoodless[1] and Legal & General[2]), and will lead to a concerning lack of independence between the enforcement team and persons at the FSA taking the regulatory decisions.

Despite vigorous push back from stakeholders regarding each of these proposals, they have all so far survived their passage through the House of Commons and into the House of Lords, and at least for now, look set to become law.

Further amendments to FS Bill to be proposed in autumn 2012

Fines

The political tide continues to flow against the financial services industry; recent high profile FSA enforcement action against banks cannot have helped the mood at Westminster. In the last few weeks, the Chancellor of the Exchequer, George Osborne, announced to the House of Commons that the government will propose amendments to the FS Bill in autumn 2012, which will include amendments to ensure that fines paid by the industry to regulators go to the Exchequer. This will apply to fines received from 1 April 2012, and so will catch the FSA's fines in relation to the LIBOR enforcement action. Fines received from the industry are currently used to reduce the annual FSA levy imposed on other financial institutions.

Directors of failed banks

HM Treasury also published a consultation paper in July 2012 outlining new sanctions for the directors of failed banks. This consultation follows on from recommendations made during pre-legislative scrutiny of the FS Bill, and from the FSA's report into the failure of RBS. In the consultation paper, HM Treasury is proposing to include within the FS Bill a rebuttable presumption that the director of a failed bank is not suitable to be approved by the regulator to hold a position as a senior executive within a bank. The paper considers that this should be supported by other measures, such as clarifying management responsibilities and changes to the regulatory duties of bank directors, to be introduced by the regulators in their rules in due course. In relation to the proposal to introduce a rebuttable presumption for directors of failed banks, given the FSA's stance on senior management responsibility, this is making into law what would in all likelihood be the FSA's approach to approving such a director in a new post. Note that the consultation paper focus is on banks, and so it would appear that it is not proposed to extend the new sanctions to other non-bank financial services firms.

The consultation paper also considers the introduction of criminal sanctions for serious misconduct in the management of a bank, but concludes that

[1] http://www.fsa.gov.uk/pubs/final/hoodless_17dec03.pdf
[2] Legal & General Assurance Society Ltd v Financial Services Authority, Financial Services and Markets Tribunal, 13 January 2005

since this raises some complex issues, there is not sufficient time to work through these to include them within the FS Bill.

Professional standards in banks

In the aftermath of the enforcement actions concerning Libor rate-fixing, David Cameron established a Parliamentary Commission on Banking Standards, chaired by Andrew Tyrie, a conservative MP.

The Commission is to report on legislative proposals by 18 December to be included in FS Bill. It is currently taking written evidence.

Essentially the Commission is looking at whether professional standards are absent or defective, how they compare to other professions and consequences for retail and wholesale customers and the economy.

An aspect of this will include looking at the root causes of poor professional standards e.g. culture, incentives (e.g. to take risks), globalisation, financial innovation, corporate structure and retail and investment banking – there is considerable overlap with a number of other reforms undertaken or in progress.

LIBOR reform

HM Treasury also published in July 2012 a discussion paper outlining Martin Wheatley's initial views on LIBOR reform. This paper sets out suggestions for improving the LIBOR calculations mechanism and improvements to the governance of the LIBOR process plus potentially bringing the LIBOR submission and administration process within the ambit of regulations under FSMA.

There are also proposals to beef up the market abuse and criminal sanctions regimes, and to widen the scope of S397 FSMA (misleading statements or actions).

Comments on the discussion paper are requested by 7 September 2012, with a view to legislative proposals being included within the FS Bill.

Structural/operational progress towards new supervisory structure

FSA's new operating model – twin peaks

The FSA began re-organising itself in April 2011 towards the new structure, when it split into two business units – the Prudential Business Unit and the Conduct Business Unit. In April this year, the FSA then split banking and insurance supervision into the Prudential and Conduct Units, so now FSA personnel are operating the legal structure under the FSA umbrella that will exist next year once the FS Bill is in force.

More specifically, what this means is that there are now two independent groups of supervisors for banks, building societies, insurers and major investment firms covering prudential and conduct. In the words of Hector Sants, the supervisors will carry out "independent but coordinated regulation"

that is “designed to allow internal coordination between both conduct and prudential supervisors to maximise the exchange of information relevant to their individual objectives, but with supervisors making independent decisions and acting separately when engaging with firms”.

Mr Sants has also been keen to emphasis that the principle of seeking to ensure that regulatory data is only collected once is retained, something which has been of concern amongst those that are likely to be dual-regulated in 2013.

So what does this mean for firms? Mr Sants in the FSA’s Business Plan for 2012 thinks that firms who are dual-regulated, they will experience a change in the approach and assessment of prudential and conduct matters as they begin working with two independent supervisory teams. These firms will have received, or will be shortly receiving, a risk assessment from each Business Unit, and supervisory decisions and communications to firms will be clearly identified as prudential or conduct. For firms that will be solely regulated by the FCA, they should however experience more limited change to supervisory processes as a result of ‘twin peaks’, although changes in the supervisory approach should be evident, with a more focused approach to prudential and conduct issues and bolder, earlier intervention to tackle potential risks to consumers and market integrity.

Most firms should by now have been contacted by the FSA so that they know who their new key supervisory contacts are.

One of the key concerns raised by stakeholders with the new structure was co-ordination between FCA and PRA, and whether the new bodies will co-ordinate between themselves and therefore avoid duplication for firms as well as underlaps/overlaps in their supervision. Draft Memoranda of Understanding (“**MoU**”) were published in this respect in January 2012, alongside the FS Bill. In relation to the PRA/FCA MoU, concerns have been raised that it is too vague, and there are questions as to how it will work in practice. In particular, once the regulators start to build their own working practices and culture, and persons are employed who have not had previous working relationships with each other.

The FSA’s Business Plan for 2012 states that the FSA will continue work with the Bank of England and HM Treasury to further develop draft MoU (and supporting documentation such as operating manuals and service level agreements) underpinning this relationship.

The interim FPC

At present, and since February 2011, the FPC has been operating in an interim capacity. The interim FPC was established by the government to undertake, as far as possible, the macro-prudential role of the FPC which is to be established in the FS Bill. The interim FPC’s main remit is to do preparatory work to help determine which macro-prudential tools are appropriate for the statutory FPC to have in its tool kit.

The FPC also makes recommendations that the FSA needs to consider under its current legal status, which must be then implemented in an effective, timely fashion or the FSA must explain why it is not implementing the recommendations. Following a Bank of England discussion paper on macro-prudential tools published in December 2011, the FPC published a statement on 23 March 2012 setting out its main recommendations to HM Treasury regarding the appropriate macro-prudential tools for the FPC. The Government also published recently its consultation paper on regarding appropriate tools for the FPC. Consultation on this closes on 11 December 2012.

Approach of new regulators

The new rulebooks

The FSA published recently a consultation paper on changes that are to be made to its rulebook in light of the move to the new regulatory structure, and which it developed jointly with the Bank of England. The consultation is focused on authorisation and supervision aspects of the Handbook. Consultation closes on 12 December 2012. The move to the new regulatory structure will mean that both the PRA and the FCA will need their own rulebooks. The FSA states in the paper that “the overall approach to amending the rulebook… is based on making only those changes that are required to implement properly the [FS] Bill and to support the creation of the new regulatory structure”. As a result, most of the provisions in the FSA handbook will be carried forward to the new rulebooks, and simply adopted or “designated” by each regulator to make up the new FCA and PRA rulebooks. Many of the amendments are therefore concerned with nuts and bolts type provisions to convert one rulebook into two, and to reflect the existence of two regulators where before there was just the FSA. The FSA will publish a designation of the existing Handbook before the legal cutover date, to provide guidance on the way that the Handbook contents will transition to the FCA and PRA Handbooks.

For example, a new provision is being added to GEN 2 to provide that where rules or guidance are being retained in both rulebooks, firms must interpret them as applying only to the extent that they are within each regulator’s powers (thus reflecting the fact that the PRA and FCA may have different regulatory responsibilities in respect of the same rule/guidance). This would need to be carried out by firms presumably with reference to the MOU between the FCA and PRA that sets out their responsibilities. Although the FSA states that reminders will be placed at intervals throughout the Handbooks for firms to do this, this potentially adds a layer of complexity to interpreting the Handbooks at a time when firms will be struggling to fully embrace all the changes brought by the new regime. There are also provisions explaining the PRA’s and FCA’s respective roles and responsibilities in relation to authorisations, variation and cancellation of

permissions etc., and to whom a firm should apply to depending on the type of application.

However, the FSA points out in the paper that some substantive changes are required to the rulebook in order for the rulebooks to reflect the FCA's and PRA's objectives and functions and in some cases, more expansive powers than those enjoyed by the FSA. For example, the FCA will be able to require a skilled person to report on a recognised investment exchange ("RIE") (including all members of a RIE group), and also to contract directly with skilled person, but with the relevant firm picking up the bill. Currently, the FSA can effectively only direct a firm to appoint a skilled person.

Further papers are expected over the coming months to cover further changes to the Handbook. The FSA has also published FAQs that cover the transition to the new Handbooks.

FCA approach to regulation

Although there has not been any further policy papers from the FSA in respect of the FCA approach to regulation since a consultation paper published in June 2011[3], there have been a number of speeches given by representatives of the FSA/FCA (Martin Wheatley and Clive Adamson) in which they have largely affirmed proposed regulatory approaches of FCA set out in the consultation paper and previous speeches. In respect of the FCA, the approach remains that:

- The FSA's enforcement approach and credible deterrence policy will be maintained by the FCA;
- A more forward looking, and interventionist approach will be adopted to identify and intervene in future risks before they become a problem;
- The FCA will be looking to address underlying root causes of problems and not just the symptoms as they arise;
- There will be a focus on a firm's culture, how they incentivise their staff and how decisions are made at the highest level;
- A clearer, sector based approach, although reviews will be carried out on a firm by firm as well as a sector basis;
- The FCA will look to secure redress for consumers where detriment occurs; and
- There will be more focus on intelligence and data;
- A more flexible, efficient approach with fewer large firms having fixed supervisory teams;
- The wholesale markets should be efficient, fair and orderly and consumers should not suffer detriment from wholesale activities.

3 See http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

> However the FCA will only intervene in wholesale markets where consumer detriment is a concern, and the caveat emptor principle shall remain.

The FSA also published in May 2012 a draft statement of policy in respect of the FCA's powers to make temporary product intervention rules under the FS Bill, and as required by the FS Bill.

The ability for the FCA to make temporary product intervention rules has been viewed with some trepidation by the industry, and is viewed as one of the potentially more powerful weapons in the FCA's armoury as a pro-active, interventionist regulator focused on protection of consumers. The range of rules that may be made is extensive, and could include requiring certain products to be excluded or changed, or requiring amendments to promotional materials or imposing restrictions on the sale or marketing of a product.

Of particular concern is the ability for the FCA to make these rules without first consulting publicly, at least where the FCA considers that the delay involved in carrying out a public consultation would be detrimental to the interests of consumers. Of some comfort is the statement in the policy that confirms that the FCA expect their use of these powers to be limited, and in assessing whether to make rules, they will take into account whether intervention is a proportionate response to the perceived risk to consumers.

The policy statement also sets out other factors that the FCA must take into account before exercising its powers to make rules, including the potential scale of detriment in the market – if involving products with a large customer base, this situation is more likely to lead to product intervention, as well as situations likely to lead to a high level of detriment for individual customers, or for vulnerable customer groups.

Any agreements entered into in contravention of product intervention rules may be unenforceable, and the rules may provide for money/property to be returned plus compensation paid. This gives product intervention rules similar penalties to breaching the general prohibition in the UK (e.g. carrying out regulated activities in the UK without authorisation from the FSA) or the financial promotion restriction, and harsher penalties than those typically imposed currently for a breach of FSA rules.

The PRA's approach to regulation

As with the FCA, there have been no further policy papers of substance on the PRA's approach to regulation since the Bank of England/FSA paper in May 2011. However, there have been two further papers published that provide some helpful information. One is a Bank of England/FSA joint paper on how the PRA will consult[4]. The paper confirms that the PRA is required to publish an annual report detailing how it has discharged its functions in the previous year, and on which it will invite public comment. The PRA must publish proposed rules in draft. The firms that the PRA regulates and other

[4] See: http://www.bankofengland.co.uk/publications/Documents/other/financialstability/pra_consultation120227.pdf

stakeholders will be given the opportunity to express views. The PRA will not have a standing practitioner panel, but will draw together temporary groups from time to time, as required.

The other joint Bank of England/FSA paper is one on how they consider that the PRA will designate certain investment firms for prudential regulation by the PRA[5] rather than the FCA, powers conferred on it by secondary legislation under the FS Bill. The paper provides a bit more detail on the criteria that the PRA must use as set out in the draft order, including when assessing a firm's assets what the PRA should look to.

[5] See: http://www.bankofengland.co.uk/publications/Documents/other/financialstability/investmentfirms.pdf

Linklaters

Contacts

For further information please contact:

Sarah Parkhouse
Partner

(+44) 20 7456 2674

sarah.parkhouse@linklaters.com

Carl Fernandes
Partner

(+44) 20 7456 3002

carl.fernandes@linklaters.com

Michael Kent
Partner

(+44) 20 7456 3772

michael.kent@linklaters.com

Peter Bevan
Partner

(+44) 20 7456 3776

peter.bevan@linklaters.com

Nadia Swann
Partner

(+44) 20 7456 5232

nadia.swann@linklaters.com

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com

Author: Kirsty Gibson

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