

The Draft Financial Services Bill in the Context of the Proposed New UK Financial Regulatory Structure

This update summarises the new UK financial regulatory structure and the draft Financial Services Bill at present subject to scrutiny in the UK Parliament.

"2008 was not the end of the crisis, it was merely one stage of it"

— Mervyn King, Governor of the Bank of England

"The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version"

— J.K. Galbraith

The New UK Financial Services Regulatory Structure

The Government's proposals for reform of the UK financial services regulatory structure were announced by the Chancellor of the Exchequer in June 2010. In part, they represent a response to failures in UK financial regulation identified during or after the financial crisis which began in 2007.

Introduction

Responsibility for financial stability in the UK has hitherto been shared by HM Treasury, the Bank of England, and the Financial Services Authority (the "FSA") under what is known as the tripartite system.

In June 2010, the Government announced that it intended to abolish the tripartite system. This will result in the FSA ceasing to exist in its current form, and the establishment of three new regulatory bodies by the end of 2012: the Financial Policy Committee (the "FPC"), the Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA").

These reforms have resulted from criticism of the performance of the tripartite system in the financial crisis of 2007/8 for not anticipating the crisis and not providing decisive leadership during it.

The Coalition Government's proposals for reforms have been set out in three key papers published by HM Treasury:

- *A new approach to financial regulation: judgement, focus and stability* (July 2010);
- *A new approach to financial regulation: building a stronger system* (February 2011); and
- *A new approach to financial regulation: The blueprint for reform* (June 2011).

The third paper included a draft version of the primary legislation proposed to bring the core reforms into effect, the Financial Services Bill (the "FS Bill"). A copy of the Financial Services and Markets Act 2000 ("FSMA") as proposed to be amended by the FS Bill is available from HM Treasury. (However, it has no official standing).

The New Regulators

The Role of the Bank of England

The draft FS Bill proposes to increase the maximum possible term of non-executive directors of the Bank's Court of Directors (the BoE's governing body) to four years to ensure greater continuity, and to enable the Chancellor of the Exchequer to extend the terms of Monetary Policy Committee ("MPC") and FPC members by six months. In addition:

- Responsibility for regulating settlement systems and recognised clearing houses ("RCHs") will be transferred to the BoE (alongside its existing responsibility for payment systems). The FCA will retain responsibility for regulating recognised investment exchanges ("RIEs").
- The draft FS Bill also proposes new measures in relation to both RCHs and RIEs, including:
 - simplifying the procedures for making directions and revoking recognition to enable quick responses to threats to financial stability;
 - financial penalties and censures for breaches of regulatory requirements;
 - rule-making powers;
 - a new power to order skilled persons reports and to appoint investigators (the latter currently only exercisable against RIEs); and
 - the removal of the special competition regime in Part 18 of FSMA 2000.
- Further substantive issues will be dealt with once the European regulation for the regulation of derivative transactions, central counterparties and trade repositories ("EMIR") has been finalised.
- The draft FS Bill will also make the changes initially proposed in relation to the regulation of settlement systems, including enabling HM Treasury to empower the BoE to issue codes of practice or make rules on specified matters.
- The draft FS Bill enables the BoE to apply for a court order to prevent or remedy compliance failures within payments systems.
- HM Treasury will be able to order an inquiry into possible regulatory failures in the context of the regulation by the BoE of systemically important infrastructure.

The Financial Policy Committee (the "FPC")

The FPC will sit within the BoE. It will be responsible for the macro-prudential regulation and will consider macro issues affecting economic and financial stability. It will respond to any such issues by directing the PRA (and, where necessary, the FCA) to take the necessary action, which may include the use of new macro-prudential tools. The FPC will not itself directly supervise any firms.

Responses to the Government's earlier consultation supported the Government's plan to establish the FPC as a committee of the BoE and its objective remains as proposed, namely to contribute to the objective of the BoE to protect and enhance financial stability, through identifying and taking action to remove or reduce systemic risks, with a view to protecting and enhancing the resilience of the UK financial system.

In exercising its functions, the FPC:

- may not act in a way that it believed would be likely to have a significant adverse impact on economic growth; and
- must have regard to proportionality, openness and international law.

The functions originally outlined for the FPC remain essentially the same, namely to:

- monitor the stability and resilience of the financial system, with a view to identifying and assessing systemic risks; and
- use the following tools to address those risks:
 - public announcements and warnings (e.g., to publicise a concerning trend in financial services);
 - influence of macro-prudential policy at the European and international levels;
 - recommendations to bodies other than the PRA and the FCA; and
 - powers over the PRA and FCA to make recommendations, backed up by a comply-or-explain mechanism (e.g., that firms disclose certain information); and to direct the PRA and FCA where explicitly provided for by macro-prudential tools (e.g., variable risk weights and liquidity tools) designed in secondary legislation.

The FPC will not have direct powers over regulated firms. Directions and recommendations from the FPC to the PRA and FCA cannot be directed specifically at an individual firm. Given the

concentration of the UK financial services sector, this may not prevent a measure designed to preserve financial stability more generally from in practice catching the behaviour of a very small number of large institutions.

The Prudential Regulation Authority

The Prudential Regulation Authority (the “PRA”) will be a subsidiary of the BoE. It will be responsible for micro-prudential regulation of those firms that the Government believes should be subject to significant prudential regulation. These firms include banks, building societies, insurers, and certain investment firms considered to be of systemic importance. These firms are sometimes referred to as “dual-regulated firms”, as they will also be regulated by the FCA for conduct purposes.

As regards the PRA’s objective, some significant changes are proposed in the FS Bill which include:

- Taking into account the views of the insurance sector, the Government has recognised that the distinct nature of insurance business should be recognised in the regulatory framework. The draft FS Bill makes explicit reference to the responsibilities of the PRA with respect to insurers in the creation of a separate insurance objective: “contributing to the securing of an appropriate degree of protection for those who are or may become policyholders”.
- The PRA will be required to give guidance on two matters:
 - how the PRA intends to advance its objectives in relation to different categories of PRA-authorized persons or PRA-regulated activity (For example, the PRA must give guidance as to how it proposes to regulate PRA-authorized persons who accept deposits differently from those who effect or carry on contracts of insurance); and
 - matters which it regards as primarily its responsibility, rather than that of the FCA. This guidance, together with guidance issued by the FCA, should make the division of responsibilities between the PRA and the FCA more transparent. The PRA must consult the FCA before issuing such guidance.
- A new section has been included to make clear that the new regime will not be operated on a “zero-failure” basis.
- A new provision provides that, where a rule proposed by the FCA or PRA is to apply both

to mutual societies and other authorised persons, the regulator must publish with the draft rule a statement indicating whether the rule will affect mutual societies significantly differently from other authorised persons and details of the difference.

The Financial Conduct Authority

The FCA will:

- be responsible for the conduct of business regulation of all firms, including dual-regulated firms;
- inherit the majority of the FSA’s market regulatory functions, including the FSA’s role as the UK Listing Authority (the “UKLA”); and
- be responsible for the prudential regulation of firms not regulated by the PRA.

The Government intends to give the FCA a number of powers in addition to those currently held by the FSA. These include powers to:

- make temporary product intervention rules, allowing it block an imminent product launch or to stop an existing product;
- require firms to withdraw or amend misleading financial promotions with immediate effect; and
- publish details of the start of enforcement proceedings against a firm for rule breaches or compliance failings.

As regards the FCA’s objectives and general approach, the Government is proceeding with its previous proposals for the FCA to have a strategic objective to protect and enhance confidence in the UK financial system, and with operational objectives to protect consumers and promote market integrity, efficiency and choice. The FCA will be required to discharge its functions in a way that promotes competition.

The FCA will have a considerable degree of discretion when determining whether to invoke its powers to ban, or temporarily impose requirements on products. The trigger will be when it appears to the FCA to be necessary or expedient for the purposes of advancing its consumer protection or competition objective. The draft FS Bill expressly states that the power cannot be used to advance its market integrity objective (unless permitted by an order of HM Treasury) in response to concerns that the power is unlikely to be appropriate to the protection of professional or wholesale customers.

However, somewhat controversially, the FCA will be able to make temporary product intervention rules, valid for up to 12 months, without any prior cost-benefit analysis or consultation. Nevertheless, the draft FS Bill contains some, albeit limited, safeguards on the FCA's use of these powers. The FCA will be:

- required to consult on and publish a statement of policy governing the circumstances in which it may make temporary product intervention rules;
- prohibited from making further temporary rules which are substantially the same as temporary rules which have lapsed within one year; and
- required to consult and issue a cost-benefit-analysis if it wishes to extend the temporary product intervention rules beyond 12 months.

The draft FS Bill also contains new powers for the FCA to direct a firm to withdraw or refrain from issuing misleading financial promotions with immediate effect, so as to prevent consumers from being misled. The draft FS Bill imposes a duty on the FCA to publish directions made under this new power in order to increase the visibility of its activities and to clarify good and bad practice and contains some safeguards that are intended to mitigate the risk of reputational damage to firms, namely the FCA will:

- be required to warn a firm of its proposed direction action, and to consider representations before publishing any details of its action; and
- have discretion as to the contents of the direction (although it will have a duty to publish the direction). (For example, it may include a summary of the firm's representations where it disputes the direction.)

As regards the competition powers of the FCA:

- the FCA will have a "wide competition mandate" so as to enable it to take "significant action in pursuit of competition", (such as the promotion of current account switching); and
- the draft FS Bill contains a new power for the FCA to refer to the Office of Fair Trading (the "OFT") possible competition issues (for example, structural features in a market or potential collusive business practices) which may require technical competition expertise or resolution by the competition authorities.

The OFT will then be obliged to respond within 90 days.

Publication of Warning Notices

The Government has remained committed to giving the FCA and PRA a controversial power (although not a duty) to publish the fact that a warning notice has been issued, and a summary of the notice. This is notwithstanding acknowledged concerns regarding reputational damage and the potential for consumer confidence to be undermined.

However, a number of broadly-based safeguards are contained in the draft FS Bill, namely that the regulators may not publish a warning notice if it would be:

- unfair to the person to whom the warning notice relates;
- prejudicial to consumer interests; or
- detrimental to the stability of the financial system.

Further, the new regulators will now be required to consult the person to whom the warning notice relates before making the publication. (As the FCA will be conducting most enforcement activity, this tool is likely to be used primarily by the FCA in practice).

Co-ordination between the Regulators

The new structure necessitates close co-operation and co-ordination between the new regulatory bodies, to ensure consistency of regulation and to avoid duplication of efforts. The Government intends to put in place structures, such as memoranda of understanding, formalising the ways in which the regulators should co-operate.

Regulation of Dual-Regulated Firms

The PRA and the FCA will need to work closely together in respect of the regulation of dual-regulated firms, given the potential for regulatory overlap and confusion between the two regulators' respective roles.

Crisis Management Arrangements

One of the Government's main criticisms of the tripartite system's performance during the financial crisis was that regulatory bodies failed to identify the problems that were building up in the financial system and to address them adequately once the

crisis broke. The Government intends to establish a new crisis management mechanism, which will set out the roles that HM Treasury, the BoE, the FPC and the PRA are expected to perform in a crisis.

The draft FS Bill sets out the legislative mechanism for coordination. In addition to prescribing communications between the Chancellor of the Exchequer and the Governor of the BoE, HM Treasury must agree a Memorandum of Understanding (“MoU”) on the coordination and management of crises. However, there remains some potential for conflict of interest between the PRA in its role as prudential supervisor of regulated firms, and the BoE in the operation of the Special Resolution Regime. The draft FS Bill also proposes a number of changes to the Special Resolution Regime.

EU and International Issues

The jurisdictions of the new regulators do not fit neatly onto the jurisdictions of regulatory bodies outside the UK. In particular, the Government has been obliged to consider which of the PRA and the FCA should represent the UK at the new European supervisory authorities (the “ESAs”), as well as at international bodies, such as the International Organisation of Securities Commissions (“IOSCO”) and the International Association of Insurance Supervisors (“IAIS”).

However, the Government appears to recognise that EU and international reform will be equally significant to the changes taking place in the UK and has engaged with its European and international partners on the global strengthening of the regulatory regime. Responses to the previous consultations were supportive of the Government’s emphasis on the need for the UK to have a single, coherent and consistent strategy to deliver sound reform which complements the changes proposed to the UK financial regulatory framework. The Government has also stressed that whilst it has had some successes, such as in its negotiations on the Alternative Investment Fund Managers Directive, a number of challenges remain, especially concerning the new EU capital requirements legislation.

There is also to be a statutory MoU between HM Treasury, the Bank of England, the PRA and the FCA to coordinate the UK’s approach to international coordination. (The MoU on membership of, or relations with, international organisations, is provided for in clause 44 of the draft FS Bill.)

Related Reforms

It is envisaged that the PRA and the FCA will inherit the majority of the FSA’s current powers and responsibilities. However, the Government is also considering making further reforms to the existing regulatory structure beyond the core reform of passing the FSA’s powers to the PRA and the FCA. These include reforms to the Financial Services Compensation Scheme (“FSCS”), the Financial Ombudsman Service (“FOS”), and the Money Advice Service (“MAS”).

In its original proposals for the reforms announced in June 2010, the Government stated it intended to establish an economic crime agency which would inherit certain FSA criminal enforcement powers. Following the Home Office announcement in June 2011 on the establishment of a National Crime Agency, the plan to establish the economic crime agency now appears to have been shelved.

As indicated above, the Government also intends to transfer regulatory responsibility for systemically important infrastructure (i.e., settlement systems and recognised clearing houses) from the FSA to the BoE.

The Legislation

In June 2011 HM Treasury published a draft text of the FS Bill, the primary legislation which will bring the core reforms into effect.

The FS Bill largely amends existing legislation, and will make extensive changes to FSMA, as well as to the Bank of England Act 1998 and the Banking Act 2009.

Pre-legislative scrutiny (“PLS”) of the draft FS Bill has been taking place in Parliament this autumn, with the PLS Committee due to report on the FS Bill in December 2011. The Government aims to introduce the FS Bill formally into Parliament before the end of 2011.

Development of the Reforms

Before the 2010 general election, the Conservative Party announced that they would abolish the FSA and the tripartite system and give the BoE responsibility for macro-prudential regulation and maintaining financial stability.

In the Coalition Programme, published on 20 May 2010, the Coalition Government indicated its intention to transfer certain prudential regulatory functions to the BoE and to create a serious

economic crime agency, but did not clarify the future of the FSA or the tripartite system. The Queen's Speech delivered on 25 May 2010, announced that the Government intended to publish a Financial Services Regulation Bill which would reform the framework for financial services regulation. However, the only concrete proposal assigned to the Financial Services Regulation Bill at that time was the transfer from the FSA to the BoE of control of macro-prudential regulation and oversight of micro-prudential regulation.

The Chancellor of the Exchequer announced in his Mansion House speech on 16 June 2010 that the Government intended to abolish the tripartite system, resulting in the FSA ceasing to exist in its current form. Further details were provided in a subsequent statement to the House of Commons made by Mark Hoban, Financial Secretary to HM Treasury, on 17 June 2010.

The Government then set out its detailed proposals in an HM Treasury consultation paper *A new approach to financial regulation: judgement, focus and stability* published on 26 July 2010, with further details in a *summary of consultation responses* published on 24 November 2010. More detail on, and clarification of the proposals were then set out in a second HM Treasury consultation paper, *A new approach to financial regulation: building a stronger system* on 17 February 2011.

On 16 June 2011, HM Treasury finally published a white paper on the reforms, *A new approach to financial regulation: the blueprint for reform*, which included a draft version of the FS Bill.

The FSA and the BoE are also in the process of publishing papers on the approach that the FCA and the PRA will take to supervision. To date they have published the following papers:

- on 19 May 2011, the FSA and the BoE published a paper on the PRA's approach to supervising banks and investment firms.
- on 20 June 2011, the BoE and the FSA published a paper on the PRA's prudential regulation of insurance companies
- on 27 June 2011, the FSA published a paper on the FCA's approach to regulation.

Deadline for Implementation of the Reforms

The Government intends for the transfer of powers to the new bodies to be completed by the end of 2012, although the FSA's 2011/12 business plan

stated that the Government expects the new authorities to become operational at the beginning of 2013. In March 2011 Hector Sants, FSA chief executive, suggested that transfer may take place in early 2013. However, in evidence given in March 2011 to the Treasury Committee of the House of Commons, the BoE Governor, suggested that the deadline might be delayed until 1 March 2013.

Nevertheless, in a response to the Treasury Select Committee published in May 2011, the Government insisted that the end of 2012 remains its deadline. Even if the Government accepts the recommendations of the Independent Commission on Banking (the "ICB"), which were published on 12 September 2011, its view was that the timetable will allow this.

The Financial Services Bill

Pre-Legislative Scrutiny

The PLS of the draft FS Bill by a joint committee of Lords and Commons has been underway and the committee is required to report on the FS Bill by 16 December 2011 (the original deadline was 1 December 2011).

Primary Legislation

The Government intends to introduce the primary legislation into Parliament by the end of 2011, although it will presumably not do so until after the PLS committee has issued its report.

Secondary Legislation

The Government has stated that the draft secondary legislation setting out the macro-prudential toolkit available to the FPC will not be published before scrutiny of the Bill begins because the timetable for developing the toolkit "relies to a large extent on international developments in macro-prudential policy". (This reference is presumably to the implementation in the EU, and consequently the UK, of the Basel III reforms.)

The PRA and the FCA

The FSA and the BoE will be publishing further papers on the PRA and the FCA, including:

- an FSA paper on the FCA's operating model, which will include further detail on its risk framework and its approach to transparency; and

- a joint BoE and FSA paper on how the PRA and the FCA will deliver operational co-ordination.

The Interim FPC

In February 2011, the Government established an interim FPC to undertake, as far as possible, the macro-prudential role of the FPC that is to be established in statute.

A key role of the Interim FPC is to undertake preparatory work and analysis into potential macro-prudential tools. In its June 2011 white paper, the Government gave an indication of its timings for this work:

- the Interim FPC will provide the Government with an update on its work on potential macro-prudential tools later in 2011 (in time for the FS Bill's introduction). Whilst the Government aims to introduce the FS Bill formally into Parliament before the end of 2011, the timing depends not only on the duration of the PLS but also on the length of time taken by the Government in considering the scrutiny committee's recommendations;
- the Interim FPC will report to the Government for a second time in the first half of 2012, after its meeting in the first quarter of 2012, and the Government expects that this will coincide with the FS Bill's committee stage in the House of Commons.

Transitional Arrangements

The FSA is currently preparing for the transition to the new structure. It is introducing a shadow internal structure this year, allocating FSA staff and responsibilities in anticipation of the creation of the FCA and the PRA. The first step, undertaken in April 2011, was to replace its risk and supervision business units with a Prudential Business Unit and a Conduct Business Unit.

Timeline: What is Next?

Date	Proposed or potential development
23 November 2011	Meeting of the Interim FPC.
1 December 2011	Publication of minutes from the meeting of the Interim FPC on 23 November 2011.
16 December 2011	Deadline for the PLS committee to present its report on the draft FS Bill.
Before the end of 2011	BoE and FSA paper on operational co-ordination between the FCA and the PRA.
Before the end of 2011	First report by the Interim FPC on its macro-prudential toolkit.
Before the end of 2011	First reading of the FS Bill.
First half of 2012	Second report by the Interim FPC on its macro-prudential toolkit.
Before the end of 2012	Expected date for Royal Assent for the primary legislation.
1 January 2013	The Government's current deadline for the completion of the necessary primary legislation and the transfer of powers to the new regulatory bodies.

The Draft Financial Services Bill

Scope

The draft FS Bill contains the core provisions for the Government's structural reforms, including the measures necessary to establish the new regulatory bodies: the FPC, the PRA and the FCA.

The draft FS Bill provides that the PRA has sole responsibility for securing an appropriate degree of protection for the reasonable expectations of policyholders as to their returns under with-profits policies. The PRA will be required to consult the FCA, and the FCA will need to provide advice, on matters relevant to achieving an appropriate balance between the interests of policyholders and

the prudential position of the firm. The Government is considering whether current provisions are sufficient or whether further explicit legislative provisions are required.

Generally, HM Treasury will specify in secondary legislation the activities which are “PRA-regulated activities” for the purposes of FSMA. The order will determine the scope of regulation by the PRA and the persons whom the PRA will regulate.

As indicated above, the FS Bill will make extensive changes to FSMA, as well as to the Bank of England Act 1998 and the Banking Act 2009. Although the majority of the FS Bill’s provisions relate to amendments to other primary legislation, it also includes freestanding provisions in Part 3 (Collaboration between Treasury and Bank of England, FCA or PRA) and Part 4 (Inquiries and investigations). (The Government decided to amend FSMA, rather than to repeal it and redraft and re-enact it, as it believed that this would minimise the impact on regulated firms and other stakeholders).

In a statement made in response to the final recommendations of the Independent Commission on Banking on 12 September 2011, the Chancellor of the Exchequer has suggested that some of the ICB’s recommendations may be implemented in the FS Bill. There are likely to be other extensive additions and amendments to the FS Bill during its passage through Parliament.

Commencement Date

The provisions of the FS Bill will generally come into force on such date(s) as HM Treasury specifies in commencement orders. The Bill will become, after Royal Assent, the Financial Services Act 2012 and it extends to England and Wales, Scotland and Northern Ireland (clause 68, FS Bill).

Pre-legislative Scrutiny

As mentioned above, the PLS of the FS Bill is now underway, on 18 July 2011, the House of Commons having approved establishing a PLS committee, a joint committee of Lords and Commons, and on 20 July 2011, the House of Lords approved it as well.

On 22 July 2011, the PLS committee launched a call for evidence as part of its inquiry into the Bill. The call for evidence contained 22 questions about the FS Bill and reforms to the UK financial services regulatory structure. In addition to the questions, the committee was interested in whether the FS Bill:

- will or could better:
 - prevent another financial crisis;
 - handle a financial crisis; and
 - deal with bank failure and protect the public purse.
- will increase or decrease the risk or regulatory arbitrage of financial businesses.

(The deadline for written submissions to this call for evidence was 2 September 2011).

The PLS committee is required to report on the draft FS Bill, after hearing oral evidence, in December 2011.

The Draft FS Bill in More Detail

Part 1 of the FS Bill: Amendments to the Bank of England Act 1998 - the FPC (Clauses 1 to 4 and Schedules 1 and 2)

Part 1 of the FS Bill (clauses 1 to 4) sets out amendments to the Bank of England Act 1998 (the “BoE Act 1998”) necessary for the establishment of the FPC and the change to the financial stability objective of the Bank of England (the “BoE”). It includes provisions on the FPC’s objective, membership and powers, as well as the accountability mechanisms that apply to the FPC.

Schedule 1 to the FS Bill sets out a new Schedule 2A to the BoE Act 1998 on the FPC’s procedures, including the appointment and removal of members. It also includes further consequential amendments to the BoE Act 1998 relating to the FPC.

Schedule 2 to the FS Bill includes further amendments to the BoE Act 1998 relating to the new regulatory structure generally and also to the BoE’s Monetary Policy Committee (the “MPC”).

Part 2 of the FS Bill: Amendments to the Financial Services and Markets Act 2000

Part 2 of the FS Bill (clauses 5 to 41) sets out the extensive amendments to FSMA necessary to enact the Government’s reforms.

The FCA (Clause 5 and Schedule 3)

Clause 5 of the FS Bill deletes Part 1 of FSMA and, among other things, inserts a new Part 1A (The Regulators), comprising Chapter 1 (The Financial Conduct Authority), Chapter 2 (The Prudential Regulation Authority) and Chapter 3 (Further provisions relating to FCA and PRA).

Chapter 1 of the new Part 1A of FSMA sets out general information about the FCA, including details of its objectives, its obligation to consult with practitioner panels and HM Treasury's power to conduct reviews of its performance.

Clause 5 of the FS Bill also deletes Schedule 1 to FSMA and inserts new Schedules 1ZA (The Financial Conduct Authority) and 1ZB (The Prudential Regulation Authority).

The PRA (Clause 5 and Schedule 3)

Chapter 1 of the new Part 1A of FSMA sets out general information about the PRA, including details of its objectives, its obligation to consult with practitioners and HM Treasury's power to conduct reviews of its performance.

Clause 5 of the FS Bill also deletes Schedule 1 to FSMA and inserts new Schedules 1ZA (The Financial Conduct Authority) and 1ZB (The Prudential Regulation Authority).

Further Provisions Relating to FCA and PRA (Clause 5)

Chapter 3 of the new Part 1A of FSMA sets out general requirements for how the FCA and the PRA should co-ordinate their activities, including details of the contents of the proposed memorandum of understanding ("MoU") on co-ordination issues and the regulatory principles shared by the regulators. It also includes provisions relating to the PRA's veto over the FCA, the consolidated supervision of groups and co-operation by both regulators with the BoE.

PRA-Regulated Activities (Clause 6)

Clause 6 of the FS Bill inserts a new section 22A into FSMA which gives HM Treasury the power to specify which regulated activities will be PRA-regulated activities. Any person that carries out a PRA-regulated activity will be a dual-regulated firm (that is, a firm prudentially-supervised by the PRA and conduct-supervised by the FCA). Orders made under section 22A may confer powers on HM Treasury, the FCA and the PRA, which will be used by the Government to grant the PRA the power to designate activities carried on by certain investment banks as PRA-regulated activities.

Permission to Carry on Regulated Activities (Clauses 7 and 8)

Clause 7 of the FS Bill amends Schedule 6 to FSMA (Threshold conditions) to introduce a new threshold

condition relating to the suitability of a firm's business model (i.e., its business strategy).

Cause 8 replaces the existing Part IV of FSMA (Permission to carry on regulated activities) with a new Part 4A. The new Part 4A of FSMA introduced by clause 8 sets out the arrangements for authorisation applications, variations and cancellations of permission (at the request of firms and at the initiative of regulators) and the imposition of requirements on firms. (These regulatory processes will require close co-ordination between the PRA and the FCA).

Passporting (Clause 9 and Schedule 4)

Clause 9 of the FS Bill introduces Schedule 4 to the FS Bill which amends:

- Section 34 and Schedule 3 to FSMA (EEA passport rights);
- Section 35 and Schedule 4 to FSMA (Treaty rights); and
- Part XIII of FSMA (Incoming firms: powers of intervention).

These amendments adapt the existing provisions in FSMA concerning passporting arrangements, both for UK firms and for firms passporting into the UK from elsewhere in the EEA, to the new regulatory structure.

The relevant prudential authority will issue notices for outward passporting firms. For inward passporting firms (and this will only appear in secondary legislation):

- the PRA will receive notices from overseas regulators under the Banking Consolidation Directive, the Consolidated Life Assurance Directive and the First, Second and Third Non-Life Insurance Directives, to enable it to have oversight of large firms branching into the UK; and
- notification under all other Directives will go to the FCA.

Approved Persons and Controlled Functions (Clauses 10 to 12 and Schedule 5)

Clauses 10, 11 and 12 of the FS Bill amend provisions in Part V of FSMA (Performance of regulated activities) to reflect the new regulatory regime. (Part V of FSMA relates to the approved persons regime and the specification of controlled functions.)

Clause 11 of the FS Bill (which amends section 59 of FSMA and introduces a new section 59A) sets out the responsibilities of the FCA and the PRA in relation to controlled functions, and their powers to specify new controlled functions. Clause 12 introduces Schedule 5 to the FS Bill, which makes consequential amendments to Part V of FSMA.

Official Listing (Clauses 13 to 19)

Clauses 13 to 19 of the FS Bill amend Part VI of FSMA (Official listing) to reflect the FCA's role as the UK Listing Authority (UKLA). They also make a number of technical amendments to Part VI.

The proposals give extended powers to the FCA to:

- require a listed issuer to commission a skilled person's report (notwithstanding acknowledged objections). This power will also apply to sponsors, which had not previously been proposed. (This addition perhaps reflects current concerns regarding sponsor responsibility.)
- sanction sponsors by imposing unlimited penalties and/or suspensions or restrictions on sponsor activity (up to a period of twelve months).
- extend the limitation period for taking action for breaches of the Part 6 rules, which include the listing rules, from two years to three years.
- give the UKLA the power to make rules for, and impose sanctions on, primary information providers, such as regulatory information services; and
- allow the UKLA to discontinue or suspend a listing at the request of an issuer without following the warning notice and decision notice procedure.

Appeals to the Upper Tribunal (Clause 20)

Clause 20 of the FS Bill amends Part IX of FSMA (Hearings and appeals) to carry forward the current right to appeal certain decisions of the FSA to the Tax and Chancery Chamber of the Upper Tribunal so that it also applies to decisions made by the FCA and the PRA. It also limits the courses of action available to the Upper Tribunal if it chooses not to uphold a decision made by the PRA or the FCA.

The Government had previously considered narrowing the grounds of referral to the Upper Tribunal, so that references of supervisory decisions of the PRA may only be heard on limited grounds

(those which could be raised on a judicial review) instead of the "full merits" review currently provided for in relation to FSA supervisory decisions. The Government has now decided to leave the Upper Tribunal's scope of review of supervisory decisions unchanged in the draft FS Bill.

Rules and Guidance (Clauses 21 and 22)

Clause 21 replaces Part X of FSMA (Rules and guidance) with a new Part 9A. The new Part 9A carries forward many of the provisions in the current Part X of FSMA. It also includes provisions relating to:

- the new FCA powers concerning product interventions (at new sections 137C to 137D and 138N to 138P) and the withdrawal of financial promotions (at new section 137P); and
- revisions to the competition scrutiny regime currently set out in Chapter 3 of Part X of FSMA.

Clause 21 also deletes Schedule 14 to FSMA 2000 (role of the Competition Commission).

Short Selling (Clause 22)

Clause 22 of the FS Bill adapts the existing provisions in Part 8A of FSMA (Short selling) on the prohibition or disclosure of information about short selling to reflect the intention for the FCA to take over the FSA's responsibilities under Part 8A.

Changes of Control (Clause 23)

Clause 23 amends the change of control regime in Part XII of FSMA (Control over authorised persons) to reflect the new UK regulatory regime. In particular, it sets out provisions for how the FCA and the PRA will co-ordinate when assessing applications for acquisitions or increases of control.

Powers of Regulators in relation to Parent Undertakings (Clause 24)

Clause 24 of the FS Bill inserts a new Part 12A into FSMA, which sets out the powers of the PRA and the FCA to impose requirements in certain circumstances on unregulated parent undertakings that control and exert influence over authorised persons.

Recognised Investment Exchanges and Clearing Houses (Clauses 25 to 30 and Schedules 6 and 7)

Clauses 25 to 30 of the FS Bill make amendments to Part XVIII of FSMA (Recognised investment exchanges and clearing houses). They transfer to the BoE the FSA's current supervisory role for recognised clearing houses ("RCHs") and make a number of technical changes to the regulatory regime for RCHs and recognised investment exchanges ("RIE") under Part XVIII.

Clause 25 introduces Schedule 6 to the FS Bill, which inserts a new Schedule 17A to FSMA (Further provision in relation to exercise of Part 18 functions by Bank of England).

Clause 30 introduces Schedule 7 to the FS Bill, which makes minor and consequential amendments to Part XVIII of FSMA to reflect the new regulatory structure.

Suspension and Removal of Financial Instruments from Trading (Clause 31)

Clause 31 amends Part 18A of FSMA (Suspension and removal of financial instruments from trading) to transfer the FSA's existing functions under Part 18A to the FCA.

Discipline and Enforcement (Clause 32 and Schedule 8)

Clause 32 of the FS Bill introduces Schedule 8, which makes a number of consequential changes to the provisions in FSMA relating to enforcement issues which reflects the enforcement roles of the FCA and the PRA, including:

- Section 20 of FSMA (Authorised persons acting without permission);
- Part VIII of FSMA (Market abuse);
- Part XIV of FSMA (Disciplinary measures);
- Part XXV of FSMA (Injunction and restitution);
- Part XXVI of FSMA (Notices); and
- Part XXVII of FSMA (Offences).

Schedule 8 also inserts a new section 415B into FSMA which specifies the circumstances in which the PRA and the FCA must consult each other on certain enforcement actions.

A key reform made by Schedule 8 is the amendment to section 391 of FSMA which will allow the FCA and the PRA the power to publish information about warning notices issued to firms marking the start of formal enforcement proceedings.

The Financial Services Compensation Scheme (Clause 33 and Schedule 9)

Clause 33 of the FS Bill introduces Schedule 9 which makes amendments to Part XV of FSMA (The Financial Services Compensation Scheme) and Part 15A of FSMA (Power to require FSCS manager to act in relation to other schemes) to reflect the new regulatory regime. In particular, it sets out provisions concerning the relationship between the Financial Services Compensation Scheme (FSCS) on the one hand and the FCA and the PRA on the other, and strengthens the accountability mechanisms relating to the FSCS.

The Financial Ombudsman Service (Clause 34 and Schedule 10)

Clause 34 of the FS Bill introduces Schedule 10 which makes amendments to Part XVI of FSMA (The Ombudsman Scheme) to reflect the new regulatory regime. It sets out provisions concerning the relationship between the Financial Ombudsman Service (the "FOS") on the one hand and the FCA and the PRA on the other. It also revises the existing regulatory regime relating to the FOS.

Lloyd's of London (Clause 35)

Clause 35 of the FS Bill revises Part XIX of FSMA (Lloyd's) to reflect the new regulatory structure and the relationship between Lloyd's of London on the one hand and the FCA and the PRA on the other.

The arrangements regarding Lloyd's are that:

- the Society of Lloyd's and Lloyd's managing agents will be dual-regulated firms; and
- Lloyd's members' agents and Lloyd's brokers will be FCA-regulated firms.

Information-Gathering and Investigations (Clause 36 and Schedule 11)

Clause 36 of the FS Bill introduces Schedule 11 which makes amendments to Part XI of FSMA (Information gathering and investigations). (Schedule 11 also makes amendments to Part XXIII of FSMA (Public record, disclosure of information and co-operation).

Schedule 11 transfers the FSA's existing information-gathering powers to the FCA and the PRA and strengthens those powers.

***Disclosure of Information and Co-Operation
(Clause 36 and Schedule 11)***

Clause 36 of the FS Bill introduces Schedule 11 which makes amendments to Part XXIII of FSMA (Public record, disclosure of information and co-operation). (Schedule 11 also makes amendments to Part XI of FSMA (Information gathering and investigations))

Schedule 11 amends Part XXIII to make consequential changes relating to the new regime and to clarify issues relating to the transfer of information between the FCA, the PRA and the BoE.

***FCA Requests to the OFT on Competition Issues
(Clause 37)***

Clause 37 of the FS Bill inserts a new section 354D into FSMA, which allows the FCA to make a request to the OFT to consider whether a feature of the UK financial services market may prevent, restrict or distort competition in the UK.

***The Designated Professional Bodies Regime
(Clause 38 and Schedule 12)***

Clause 38 of the FS Bill introduces Schedule 12 which makes amendments to Part XX of FSMA (Provision of financial services by members of the professions) reflecting the transfer of the FSA's responsibilities under the designated professional bodies regime to the FCA.

Miscellaneous Amendments to FSMA (Clauses 39 to 41)

Clauses 39 to 41 of the FS Bill set out amendments to Part XXVIII (Miscellaneous) and Part XXIX (Interpretation):

- Clause 39 grants HM Treasury powers to direct the FCA, the PRA and the BoE not to take a proposed action if it appears to HM Treasury that it would be incompatible with the UK's EU obligations;
- Clause 40 amends section 417 of FSMA (Definitions) to reflect concepts introduced under the new regulatory structure. It also inserts a new section 421ZA which provides a definition of "immediate group"; and
- Clause 41 amends section 429 of FSMA to specify Parliamentary control over certain

statutory instruments made under powers created by the FS Bill.

Part 3 of the Bill: Collaboration Between HM Treasury and the BOE, FCA or PRA

Part 3 of the FS Bill (clauses 42 to 45) sets out provisions on how HM Treasury, the BoE, the FCA and the PRA will co-ordinate their activities in respect of crisis management arrangements and international issues.

Crisis Management (Clauses 42, 43 and 45)

Clauses 42 and 43 of the FS Bill set out measures relating to the crisis management arrangements under the new regulatory structure: clause 42 contains provisions on the BoE's duty to notify HM Treasury concerning possible demands on public funds and clause 43 sets out details of the MoU between HM Treasury, the PRA and the BoE on crisis management arrangements. Clause 45 provides definitions relevant to these clauses and clause 44.

Memorandum of Understanding on International Issues (Clauses 44 and 45)

Clause 44 of the FS Bill sets out details of the MoU between HM Treasury, the PRA, the FCA and the BoE on their membership of international bodies (such as the European supervisory authorities) and the co-ordination of their international activities. Clause 45 provides definitions relevant to these clauses and clauses 42 and 43.

Part 4 of the Bill: Inquiries and Investigations Into Regulatory Failure (Clauses 46 to 58)

Part 4 of the FS Bill sets out the powers of HM Treasury to arrange independent inquiries in to possible regulatory failures. It also sets out the duties of the FCA and the PRA to investigate and report on possible regulatory failures.

Part 5 of the Bill: Amendments to the Banking Act 2009

Part 5 of the FS Bill makes amendments to the Banking Act 2009 reflecting the new regulatory structure, as well as other technical amendments to the mechanisms introduced by the Banking Act 2009.

Special Resolution Regime and Bank Administration (Clauses 59 to 62)

Clauses 59 to 62 set out technical amendments to the special resolution regime (“SRR”) introduced under the Banking Act 2009, which the Government intends to make through the FS Bill.

Inter-bank Payment Systems (Clauses 63 and 64)

Clauses 63 and 64 of the FS Bill set out technical changes to the BoE’s existing regulatory responsibilities for payment systems.

Duty to Collect Financial Stability Information (Clause 65)

Clause 65 of the FS Bill states that the PRA will take over the FSA’s current obligation to collect information about financial stability.

Part 6 of the Bill: Miscellaneous Provisions***Settlement Systems (Clause 66)***

Part 6 of the FS Bill (clause 66) makes amendments required to section 785 of the Companies Act 2006 to allow for the transfer of the FSA’s current responsibilities for settlement systems to the BoE.

Part 7 of the FS Bill: General Provisions

Part 7 of the FS Bill merely sets out the general provisions relating to the Bill, including its scope, commencement and short title.

Consultation

The FS Bill largely replicates the existing FSMA consultation requirements for rules and makes no exception for rules originating from the EU even where there may be little or no discretion as to implementation. The Government considers that it is important for the PRA and FCA to conduct their own assessment of the costs and benefits of proposed rules, as well as to keep track of the impact of regulation on UK firms. In particular:

- The draft legislation requires the PRA to prepare an analysis of costs and benefits of proposed rules as opposed to an “estimate” as currently provided for in FSMA. The PRA should strive to provide estimates where it is proportionate to do so.
- The PRA may choose how it meets its statutory duty to put in place arrangements for engaging with practitioners, so long as those arrangements are transparent.

- Unlike the FCA, the PRA will not be required to maintain a Consumer Panel.

Statutory Instruments to be made under the FS Bill

The Government envisages using statutory instruments to introduce certain aspects of the reforms, using powers under the FS Bill. The FS Bill also allows for HM Treasury to make specific future changes to the regulatory regime.

The instruments that may be made under the FS Bill by HM Treasury address the following issues:

- Prescribing the FPC’s macro-prudential measures (new section 95K, BoE Act 1998).
- Amending the FCA’s statutory objectives (new section 1F, FSMA).
- Specifying which regulated activities are PRA-regulated activities, and any consequent changes to the PRA’s statutory objectives (new sections 2D and 22A, FSMA).
- Specifying whether a particular activity or transaction should be treated as financial assistance for the purposes of new section 2I of FSMA and clauses 45 and 53 of the FS Bill (new section 2I, FSMA; clauses 45 and 53, FS Bill).
- Amending the FCA’s and the PRA’s shared regulatory principles (new section 3B, FSMA).
- Specifying matters that are primarily the responsibilities of the FCA or the PRA (new section 3G, FSMA).
- Specifying the respective responsibilities of the PRA and the FCA for threshold conditions (new section 55C, FSMA).
- Extending the scope of the FCA’s powers to make product intervention rules to include measures related to its integrity objective (new section 137C, FSMA).
- Limiting the FCA’s powers to require the withdrawal of financial promotions (new section 137O, FSMA).
- Specifying which bodies should be treated as European Economic Area mutual societies (new section 138L, FSMA).
- Adding to or restricting the descriptions of authorised person who can be qualifying authorised persons for the purposes of the powers of the FCA and the PRA to give

directions to unregulated holding companies (new section 192A, FSMA).

- Specifying the definition of the term “financial institution” for the purposes of the powers of the FCA and the PRA to give directions to unregulated holding companies (new section 192B, FSMA).
- Specifying the definitions of the terms “relevant requirement” and “appropriate regulator”, for the purposes of Part XIV (Disciplinary measures), Part XVIII (Recognised investment exchanges and clearing houses) and Part XXV (Injunctions and restitution) (new section 204A and revised sections 380, 382 and 384, FSMA).
- Specifying the rule-making powers of the PRA and the FCA in relation to the FSCS (revised section 213, FSMA).
- Adjusting the deadline by which the OFT must respond to competition requests made by the FCA under section 354D (new section 354D, FSMA).
- Specifying the commencement dates for provisions of the FS Bill (clause 69, FS Bill).

Summary of the New UK Financial Regulatory Structure and EU Comparison

The chart in the Appendix to this update maps out the landscape of financial regulation in the UK proposed in HM Treasury’s Consultation Paper “A New Approach to Financial Regulation: Judgment Focus and Stability” published on 26 July 2010 as subsequently amended by HM Treasury announcements, following which draft legislation has been prepared by the Government.

HM Treasury’s July 2010 consultation provided more detail on the reforms to the UK financial services regulatory structure originally announced by the Chancellor of the Exchequer in June 2010 (and which were the subject of a Dechert OnPoint “United Kingdom Regulatory Reform: Twin Peaks Revisited” (June 2010/Issue 9)).

As described earlier in this update, these reforms now include the abolition of the FSA and the transfer of its functions and certain other bodies’ functions to four new bodies: the Financial Policy Committee, the Prudential Regulation Authority, the Financial Conduct Authority and a new serious crime agency, the National Crime Agency.

The New EU Structure

The new EU framework is now made up of two pillars: the European Systemic Risk Council (“ESRC”) and the European System of Financial Supervisors (the “ESFS”).

The ESRC

The ESRC provides EU wide macro-prudential supervision for the first time, in the hope that this will reduce the vulnerability of Europe’s financial system to interconnected systemic risks. The ESRC’s role will be to:

- collate and analyse data in order to identify risks arising from macro-economic developments;
- co-operate efficiently with the ESFS (see below) to ensure a smooth flow of harmonised micro-level data;
- issue warnings and recommendations where the risks identified are significant; and
- oversee implementation of those recommendations.

Warnings and recommendations may be issued to the European Union as whole, to specific Member States, or to the European or national supervisory authorities. These recommendations will not be legally binding, but any failure to follow an ESRC recommendation must be properly explained.

The ESFS

The ESFS comprises a network of national supervisors working with the new European supervisory authorities, namely, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority. These new supervisory authorities have substantially greater powers than the former Level 3 Committees (CESR, etc.) which they have replaced. The new supervisory authorities are responsible for:

- developing harmonised rules by setting out binding technical standards in specific areas on the basis of criteria to be set out in EU legislation;
- drawing up guidelines to be applied by the national supervisory authorities;

- facilitating resolution of disagreements between national supervisory authorities and issuing a binding formal decision if necessary;
- building a common EU supervisory culture, for example, by developing training programmes;
- supervising entities with pan-European reach (e.g., credit rating agencies);
- ensuring a co-ordinated response in crisis situations;
- collecting micro-prudential information from national supervisors; and
- dealing with other countries on behalf of the European Union.

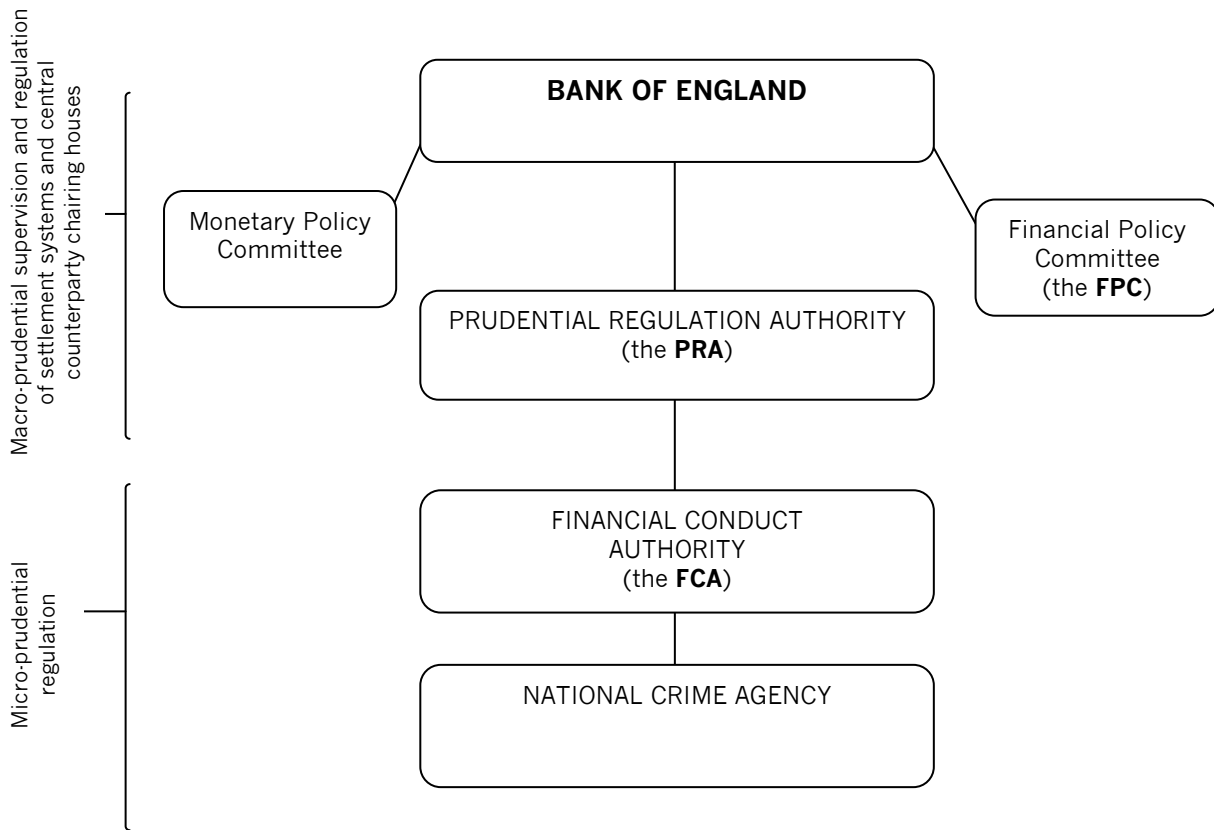
The new EU structure reflects an important shift towards centralised authority for financial services regulation in the Union. Day-to-day supervision of firms will continue to be carried out by national supervisory authorities, and the UK Government has been assured that implementation of this structure will not empower the new EU institutions to affect the fiscal responsibilities of Member States. However, it is anticipated that both the ESRC and the ESFS will wield significant influence through the recommendations of the ESRC as it reacts to systemic risks, and through the harmonisation of supervisory rules by the ESFS, such rules to be backed up by formally binding decisions where necessary.

■ ■ ■

This update was written by Martin Day (+44 20 7184 7564); (martin.day@dechert.com) and edited by Richard Frase (+44 20 7184 7692); (richard.frase@dechert.com).

APPENDIX

The New UK Financial Services Regulatory System



Practice group contacts

For more information, please contact the author, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

If you would like to receive any of our other *DechertOnPoints*, please [click here](#).

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Peter Draper
London
+44 20 7184 7614
peter.draper@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

James M. Waddington
London
+44 20 7184 7645
james.waddington@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

John Gordon
London
+44 20 7184 7524
john.gordon@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

Martin Day
London
+44 20 7184 7565
martin.day@dechert.com

Andrew Hougie
London
+44 20 7184 7373
andrew.hougie@dechert.com



www.dechert.com

Dechert internationally is a combination of limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 800 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Luxembourg, Russia, the UK, and the US.

Dechert LLP is a limited liability partnership registered in England & Wales (Registered No. OC306029) and is regulated by the Solicitors Regulation Authority. The registered address is 160 Queen Victoria Street, London EC4V 4QQ, UK.

A list of names of the members of Dechert LLP (who are referred to as "partners") is available for inspection at the above address. The partners are solicitors or registered foreign lawyers. The use of the term "partners" should not be construed as indicating that the members of Dechert LLP are carrying on business in partnership for the purpose of the Partnership Act 1890.

Dechert (Paris) LLP is a limited liability partnership registered in England and Wales (Registered No. OC332363), governed by the Solicitors Regulation Authority, and registered with the French Bar pursuant to Directive 98/5/CE. A list of the names of the members of Dechert (Paris) LLP (who are solicitors or registered foreign lawyers) is available for inspection at our Paris office at 32 rue de Monceau, 75008 Paris, France, and at our registered office at 160 Queen Victoria Street, London, EC4V 4QQ, UK.

Dechert in Hong Kong is a Hong Kong partnership regulated by the Law Society of Hong Kong.

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking action. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

Dechert in Ireland is an Irish partnership regulated by the Law Society of Ireland.

© 2011 Dechert LLP. Reproduction of items from this document is permitted provided you clearly acknowledge Dechert LLP as the source.

EUROPE Brussels • Dublin • London • Luxembourg • Moscow • Munich • Paris • **U.S.** Austin
Boston • Charlotte • Hartford • Los Angeles • New York • Orange County • Philadelphia
Princeton • San Francisco • Silicon Valley • Washington, D.C • **ASIA** Beijing • Hong Kong