FINANCIAL MARKETS LAW COMMITTEE

Appendix: Issue 157 - A non-exhaustive list of issues of legal uncertainty arising from HM Treasury's consultation entitled 'A New Approach to Financial Regulation: the Blueprint for Reform' (June 2011)[1]

CONTENTS

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1. INTRODUCTION

1.1. It is not the role of the Financial Markets Law Committee (the "FMLC") to question the policy underlying the proposals for reform. It is, however, the view of the FMLC that the implementation of this policy may in the future raise some serious issues, both conceptual and practical, for the UK markets and that it is in the interests of a robust system of regulation for these issues to be aired and addressed.

1.2. The FMLC is housed and partially sponsored by the Bank of England, but is entirely independent. Any views it expresses are its own and are not those of the Bank or any other interested party.

1.3. This appendix provides a brief and non-exhaustive list of legal uncertainty points which the FMLC has identified in HM Treasury's consultation paper entitled 'A New Approach to Financial Regulation: the Blueprint for Reform' (the "Consultation"). It also includes some proposed solutions.

2. CO-ORDINATION BETWEEN THE REGULATORY AUTHORITIES

Clause 3 of the draft Financial Services Bill (the "Bill"): the Financial Policy Committee (the "FPC") - Amendments to the Bank of England Act 1998

2.1 Section 9E(2) imposes a very low hurdle to be surmounted by the FPC before acting in a way that prejudices objectives of the Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA"). There is, however, no mechanism provided in the Bill by which the FPC will take into account the views of the PRA and FCA in striking a balance between the Bank's Financial Stability Objective and the objectives of the PRA and FPC. The absence, for example, of a duty to consult renders it unclear how the FPC will assess the existence and extent of any potential prejudice to those objectives. In view of the numerous provisions requiring consultation, the lack of a provision concerning a duty to consult increases uncertainty about the process.

2.2 By expressly setting out only one aspect of the principle of proportionality, section 9E(3)(a) creates uncertainty about the application of the other elements of proportionality, in particular the requirement that a measure should go no further than necessary to achieve the legitimate aim being pursued. The provision is also unclear regarding the method of

measurement of benefits expected to result from the burden or restriction and regarding the parties who should be taken into account for the purposes of that measurement.

2.3 Section 9H(2) specifies no basis for a decision to exclude procedural requirements in an order by HM Treasury which relates to macro-prudential measures. Express provision as to the circumstances in which procedural requirements may be disapplied would therefore reduce uncertainty.

2.4 Section 9J gives HM Treasury discretion as to whether to publish a direction made to the FCA or PRA under section 9G. If a direction is not published, it may make it extremely difficult for those affected by the resulting measures, put in place by the PRA or FCA, to review those measures against relevant provisions of the Financial Services and Markets Act 2000 ("FSMA"). It would therefore increase certainty if there was a presumption under section 9J in favour of publication and for the provision to require that any suspension of publication last for only as long as necessary to meet the interests of financial stability.

Clause 5 of the Bill: PRA and FCA – amendments to FSMA

2.5 The requirement under section 1G for the FCA to consult the PRA before giving guidance about which matters it regards as primarily its own responsibility, rather than the responsibility of the PRA, will not necessarily resolve concerns about duplication or inconsistency in the actions of the PRA and FCA. Nor will the equivalent power under section 2H, which requires the PRA to consult the FCA, necessarily resolve duplication and inconsistency. Duplication or inconsistency is intended to be dealt with by the duty under section 3D which is discussed further below.

2.6 The risk of some instability is inevitable in the financial system. However, as framed, section 2B(3) appears to suggest that the PRA should ensure its population of firms is effectively risk-free. Clarity could be improved by, for example, replacing the words "avoids any" with "minimises".

2.7 Prior to the introduction of the new section 2C ("Insurance Objective") for the PRA, the split between the FCA and PRA as far as insurance was concerned meant that the FCA would be responsible for enforcing the Conduct of Business Sourcebook / Insurance Conduct of Business Sourcebook type obligations and the PRA responsible for the prudential, i.e. INSPRU sourcebook type obligations. Section 2C creates uncertainty because the extent to which the PRA's obligations thereunder will overlap with the

obligations of the FCA is unclear. The creation of the new "Insurance Objective" could exasperate problems of co-ordination between the FCA and PRA, particularly if the PRA seeks to assert responsibility for a matter on the basis of the objective.

2.8 Section 3B(1)(b) suffers from the same uncertainty brought about by the partial inclusion of the proportionality principle as discussed above with regard to section 9E(3)(a) of the Bank of England Act 1998.

2.9 As referred to above, there are a number of aspects of section 3D that give rise to uncertainty as to how the PRA and FCA will manage co-operation and avoid possible overlaps, underlaps and inconsistencies which could create legal and regulatory uncertainty and impair the effectiveness of the proposed regime. In particular:

(a) It is not clear under section 3D(1)(a) how the PRA or FCA will determine whether the exercise of its functions may have a material adverse effect on the other.

(b) The carve-outs in section 3D(2) seem to neuter the obligation to co-ordinate. Under section 3D(2)(a), if the PRA or FCA concludes that co-ordination is not compatible with the advancing of its own objectives—which will inevitably be the case when one regulator decides to exercise its powers in a way which is likely to be adverse to the achievement of the other regulator's objectives—then the reluctant regulator will not be under the obligation to co-ordinate. As regards section 3D(2)(b), it is unclear why the burden that co-ordination puts on the regulator—relative to the benefits of compliance—is an appropriate test, or how the cost-benefit analysis would work.

2.10 Section 3E(1) provides for the publication of a memorandum in general terms by the PRA and FCA in relation to regulatory co-ordination. Although the list in section 3E(2) is not exhaustive, it is not clear that the memorandum is required to set out a mechanism for the timely resolution by the regulators of boundary and other issues between them. In view of the practical importance of this issue an express reference to this requirement in section 3E would be useful to reduce uncertainty. Legal certainty would also be aided by a requirement for the memorandum to set out how the regulators will ensure consistent interpretation of provisions that are applicable to each of them, though this may be better expressed as a regulatory principle in section 3B.

2.11 Section 3F shifts responsibility for "With Profits" policies to the PRA. Responsibility for the interests of the policyholder and their reasonable expectations, which the FCA might be

expected to take on, is, pursuant to section 3F, transferred to the PRA, which could, as with the new "Insurance Objective", give rise to issues surrounding co-operation and co-ordination.

3. ENFORCEMENT

Warning notices – amendments to FSMA

3.1 Some legal uncertainty is inherent in the discretion given to the PRA and FCA in deciding when to publish or not to publish warning notices, what details to publish and in what manner.

3.2 There are safeguards (substantive and procedural) by which firms may challenge such decisions and these must be considered for uncertainty:

(a) Under section 391(6)(a), a decision to publish can be challenged for unfairness. This provision creates legal uncertainty as it is not clear what will constitute "unfairness" and there is no detail as to what objective criteria a decision will need to satisfy in order for it to be challenged for "unfairness".

(b) There is uncertainty as to the process for challenging decisions to publish as it is not clear whether the process (including timing) will be the same as that currently used for disputing the giving of a warning notice under section 387 FSMA. Clarification as to whether this is the case and, if it is not, further detail in section 391, would reduce this uncertainty.

3.3 Section 395(1), regarding the issuing of statements of policy on, *inter alia*, warning notices by the FCA and PRA, is unclear as to whether it covers the FCA and PRA policy on the publication of warning notices because the text refers specifically to the "giving" of notices.

Appeals to the tribunal – amendments to FSMA

3.4 Rights to refer a regulator's decision on appeal to the tribunal are changing, so that in some areas there will be no such right—other than by means of judicial review where the relevant grounds can be satisfied—and in some cases, where the right exists, the tribunal will not be entitled to come to a view on the merits of the decision being challenged so as to substitute that decision for its own. It is important for legal certainty that a body of case law can

develop to inform firms and their advisors on the application of new powers and a wider recourse to the tribunal would in this way increase certainty.

4. AUTHORISATION, PERMISSION AND REGULATED ACTIVITIES

Regulatory processes

4.1 Paragraphs 2.134-137 of the Consultation are not favourable to suggestions for "shared services" or a "single point of contact" for regulatory processes, preferring an approach whereby the PRA and FCA develop their own systems. Such a developmental approach may not provide firms with legal certainty or clarity in their dealings with the regulators during the development and improvement of these systems.

Authorisation – amendments to FSMA

4.2 Applications for authorisation must be made to the "appropriate regulator" in accordance with section 55A(2). Section 55U gives each regulator the freedom to develop its own application processes and approach to the provision of information with respect to authorisation applications. This creates uncertainty for firms regarding the process, timing and paperwork of the authorisation process required for authorisation. This might be the case particularly for firms that initially sent their application to the "wrong" regulator; a circumstance acknowledged in section 55G.

4.3 Section 55C provides a mechanism whereby the regulators may arrange among themselves which of them is to be responsible for ensuring compliance with particular threshold conditions. The mechanism is expressed as a power, rather than an obligation, but there is uncertainty as to how compliance by a firm regulated by both the PRA and FCA will be ensured if no such arrangement is reached.

Approved persons regime – amendments to FSMA

4.4 Under section 59 both regulators have the power to designate controlled functions, although the PRA is stated in the Consultation (paragraph 2.160) to have "primary responsibility" for designating significant influence functions. Section 59A provides that the FCA must "keep under review" the exercise of its power to designate significant influence functions and exercise that power in a way which it considers will "minimise the likelihood that approvals fall to be given by both the FCA and the PRA" in respect of performance by an individual of a significant influence function. The section leaves uncertainty as to how a firm might deal

with a situation where its approved persons are subject to overlapping or inconsistent requirements imposed by the two regulators.

4.5 Under section 63 both regulators have the power to withdraw an approval, even if the approval was granted by the other regulator (in the case of the PRA, where the function is a significant influence function in a PRA-regulated firm). As it seems that both regulators are entitled to take action against an approved person, it remains unclear whether a firm, or a relevant individual, will, at a time when difficulties are in any event being encountered, need to deal separately with the two regulators in relation to the same set of circumstances.

Change in control – amendments to FSMA

4.6 Applications for change in control approval are to be made to the "appropriate regulator" and each regulator is given power to specify the form in which such application must be made and the information which is required to accompany it. It seems possible that the two regulators may, over time, develop quite separate processes and approaches. There is therefore uncertainty as to whether, in the case of an acquisition of a group including both PRA and FCA regulated firms, the acquirer may be required to go through two, potentially different, processes of approval.

Other issues – amendments to FSMA

4.7 As regards regulated activities, it is difficult to comment on many practical aspects of the proposals in the absence of a definition of "PRA-regulated activities". Although it is clear that banks and insurance companies are to be PRA-regulated, there is at present no clarity as to how "systemically important investment firms"—which are also intended to be regulated by the PRA—are to be identified, but that will presumably be through the definition of "PRA-regulated activities". Uncertainty is created by the fact that the Consultation (paragraph 2.58) suggests that the PRA is to have the power to designate firms for prudential supervision, whereas clause 6 of the Bill gives HM Treasury the power to specify PRA-regulated activities for the purposes of the Bill. Greater clarity as to whether there is to be a quantitative or other objective test to identify "PRA-regulated activities", how such a test would work and the extent to which the PRA will exercise discretion on a firm-by-firm basis would increase legal certainty in this area.

4.8 The threshold conditions set out in Schedule 6 to FSMA are to be amended by the insertion in the "suitability" condition of a new requirement that the firm satisfy the regulator that its

"strategy for doing business" is suitable, having regard to the regulated activities that the firm carries on or seeks to carry on. Uncertainty arises as it is not clear how this new continuing obligation (distinct from the current application requirement to present a business plan) will be applied in practice.

5. PASSPORTING

5.1. Schedule 3, part 1, paragraph 2 of FSMA includes within the scope of "the banking co-ordination directives" the Capital Requirements Directive 2006/48/EC (also known as "CRD I") as amended by implementing Directive 2009/111/EC (also known as "CRD II"). The European Commission adopted the Capital Requirements Regulation and a revised version of the Capital Requirements Directive ("CRD IV") on 20 July 2011.[2] The latest legislative package replaces CRD 1 and the Capital Adequacy Directive 2006/49/EC. To avoid legal uncertainty, it would seem sensible that, as part of the changes which the Bill introduces, FSMA is amended to reflect these changes.

5.2. Schedule 3, part 2, paragraph 14(4) of FSMA as amended defines the "appropriate UK regulator" relevant to incoming EEA firms as "whichever of the FCA and the PRA is the competent authority for the purposes of the relevant single market directive". This may mean that systemically important financial institutions (excepting banks) that are incorporated in the UK will be regulated by the PRA, but could be subject to the Markets in Financial Instruments Directive ("MiFID") for passporting. The Bill could avoid this uncertainty if the proposed definition of "appropriate UK regulator" and the associated passporting arrangements were amended or clarified as to who the competent authority would be for such incoming dual regulated firms.

6. LISTING AND EXTRA-TERRITORIALITY

6.1 The removal of the existing section 72(1) of FSMA creates uncertainty as to the designation of the UK's central competent authority required by article 21(1) of the Prospectus Directive. It may be that HM Treasury will use its current power under Schedule 8 of FSMA to designate the FCA as the UK's competent authority for this purpose but this is not clear.

6.2 The removal of the specific duties imposed on the UK Listing Authority (the "UKLA") under the existing section 73 of FSMA and the subjection of the listing authority to the same

[2] http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd [last accessed 29 July 2011].

duties as the FCA may produce legal uncertainty because both the listing and the conduct of business elements of the FCA will be subject to the same strategic objective (protecting and enhancing confidence in the UK financial system) and operational objectives (including securing an appropriate degree of protection for consumers). However, the FCA will be constrained when carrying out its functions as the UK's competent authority for the purposes of the Prospectus Directive. Although perhaps unlikely, it is theoretically possible that the FCA will be forced by compliance with EU obligations to do things that put it in breach of its statutory duties. Section 1B(1) of FSMA as amended deals with this conflict to some extent by only requiring the FCA to discharge its general functions in accordance with the strategic and operational objectives "so far as is reasonably possible" but more clarity is needed.

6.3 The removal of the existing section 73 of FSMA may create legal uncertainty through the removal of a number of matters to which the UKLA must have regard in carrying out its functions. The new section 1B(4) of FSMA does retain a requirement for the FCA to discharge its duties in a way that promotes competition but this is subordinate to the strategic objective and operational objectives. The loss of the controlling principles in the current section 73 of FSMA, coupled with the new regulatory tool allowing product intervention, is likely to deprive issuers and other primary market participants of the certainty they currently enjoy. At present, except in extreme cases where an issuer or an issue is clearly unsuitable for admission to the regulated markets, provided the requirements of the Prospectus Directive regime are complied with the UKLA must grant admission to the UK's regulated market. This certainty is threatened because the competent authority will be subject to the same duties as the conduct of business division (including the overriding operational objective to protect consumers) and the competent authority will have the power to intervene in the design of products. It appears necessary to make clear in law that the regulatory tools that are available to achieve consumer protection will be used somewhat differently, depending on whether the FCA is engaged in listing or conduct of business regulatory activity.

7. RULES AND GUIDANCE

The product banning power

7.1 Para 2.100 of the Consultation suggests that product bans are only intended to be used in a retail context. However, the definition of consumer in the new section 1C of FSMA is very

wide creating uncertainty as to the extent of the power. If the intention is that the FCA should only be entitled to use this power in a retail context, a narrower definition of "consumer" might increase certainty.

7.2 Section 137C(5)(a) of FSMA could be interpreted as allowing the FCA to use its product intervention powers to ban products that are currently not regulated by the Financial Services Authority (e.g. credit cards and personal loans). If this is not the intention, a revision of the section might reduce uncertainty.

7.3 Section 137C of FSMA deals with the FCA's general duties with respect to product intervention. Section 137C(5) of FSMA seeks to exclude certain items as relevant factors in the making of any order under section 137C(1) of FSMA. The effect of these provisions is that the FCA, in deciding to make product intervention rules, may ignore the fact that the person with whom an authorised person enters an agreement in the course of promoting, selling or otherwise carrying on an activity with respect to a financial product is another authorised person. This appears to be at odds with the current principle of variable degrees of protection for counterparties under MiFID and the scheme under the Financial Services Authority's Conduct of Business Sourcebook with an authorised person, in effect, enjoying more discretion in the context of its dealings with an eligible counterparty such as, *inter alia*, another authorised person. The principle of differential treatment rests on, *inter alia*, the FCA's consumer protection objective, embodied in section 1C of FSMA and paragraph 2.100 of the Consultation states that the product banning power is unlikely to be appropriate in relation to the protection of professional or wholesale customers. Excluding the factors in section 137C(5) of FSMA may give rise to legal uncertainty as to the proper and consistent application of the consumer protection measures in the context of the product banning power, suggested by the proposed section 137C(1)(a) of FSMA.

7.4 The effect of the product intervention powers in section 137C(1) of FSMA is such that it would, as a matter of the proper application of any test of proportionality under section 6 of the Human Rights Act 1998, be difficult to justify the exclusion of the items in section 137C(5) of FSMA. This potential conflict gives rise to uncertainty as to the application of section 137C(1) of FSMA where the product in question is intended for use by authorised persons.

7.5 Section 138N of FSMA allows the regulator wide discretion to disapply the obligation to consult under section 138J of FSMA in the case of temporary bans. In the absence of a

product pre-approval process and of a right of appeal to the Tribunal for affected firms, strong safeguards are required to ensure that legal certainty is maintained in relation to existing contractual arrangements, except for in the most serious of cases.

7.6 Section 138O of FSMA gives the FCA the power to make temporary product intervention rules and section 138N of FSMA creates exemptions from the consultation requirements for temporary product intervention rules. Sections 138C(5) and 138C(6) of FSMA have the effect that the FCA cannot extend the rules beyond a 12-month period without following the general rule-making procedures. It would appear more consistent with the temporary or emergency nature of the power if the FCA were to be obliged to make use of the full and proper consultation procedures as soon as practicable after making use of the temporary product intervention rules.

Directions regarding financial promotions: amended section 137P FSMA

7.7 Subsection (3) could be interpreted not only as preventing firms from reissuing banned financial promotions with minor amendments but also as imposing a positive obligation on firms to review and assess other financial promotions that they may have in issue at the time to decide whether those should also be withdrawn. A clarification in the text would reduce this uncertainty.

General powers of intervention

7.8 In general, there is no clear delineation of the basis on which the powers of intervention, for example those given under section 137C, are to be exercised. Intervention may take place where considered "necessary or expedient" for the purpose of advancing the consumer protection or efficiency and choice objective - where the integrity objective is relevant, then the Treasury must first have made an order to apply the relevant section. There is a danger that as the basis for the use of these powers is unclear, issues surrounding the predictability and transparency of their use will arise.

8. ADMINISTRATIVE DISCRETION AND OTHER POWERS ISSUES

Judgment-led supervision (referred to in the Consultation and previous approach papers published by the Bank of England and Financial Services Authority)

8.1 The FMLC's Issue 157 Paper dated December 2010 (available at http://www.fmlc.org/papers.html) discusses more fully the legal uncertainty which appears

to result from judgment-led supervision. The Paper points out, in particular, that moving away from compliance with specific rules may have the effect that "there will be nothing that will provide regulated persons with bright lines for individual self direction for their operations on a day-to-day basis".

8.2 Details on how and when powers will be exercised, and how the regulators will coordinate in exercising these powers, are not included in the Bill and it is instead intended that Memorandums of Understanding and statements of policy cover these issues. There may be legal uncertainty until these documents have been developed.

Power to direct unregulated holding companies: Part 12A FSMA

8.3 The breadth of the proposed power of direction over parent companies of UK authorised firms presents a number of possible issues of legal uncertainty.

(a) The power gives discretion to HM Treasury to define both (i) the kinds of UK authorised subsidiaries whose parent companies may be directed (section 192A(4)) and (ii) the persons who may be directed, that is the nature of business of the parent, and conceivably its location of incorporation (section 192B(8)).

(b) The power in section 192B(8)(a) appears to allow HM Treasury to remove the limitation that directions can only be applied to financial institutions, creating significant potential uncertainty as to how or to whom the powers will be applied. The wording of section192B(8)(2)(b) could also be construed as allowing HM Treasury to change the application of the provisions to go beyond parent bodies corporate incorporated in the UK.

(c) The trigger for exercise of the power under section 192B is widely drawn, leading to uncertainty. For example, under section 192B(5) the power of direction may be exercised if the regulator considers that acts or omissions of the parent "may" have a material adverse effect on the regulation of "one or more qualifying authorised persons". This is arguably not limited to the directed person's own subsidiary or subsidiaries and would perhaps benefit from narrowing to refer to the relevant authorised persons.

(d) It appears that the use of the power could fundamentally damage the private legal rights of parties dealing with the parent company, in particular, creating significant legal

uncertainty for creditors and shareholders of the parent were the parent forced to provide additional capital or liquidity for a subsidiary. The use of the power could cause a parent to breach undertakings or comfort letters given to other non-UK regulators. Listed parent companies may also face difficulties in making accurate financial and other public statements

(e) Regarding the ability to appeal or challenge the use of the power, the requirement under section 192F for a person to be "aggrieved" before referring a matter to the Tribunal adds uncertainty.

(f) At a general level, the power, as currently drawn, appears to introduce legal uncertainty by potentially undermining the principle of separate legal personality between parents and subsidiaries.

9. SYSTEMATICALLY IMPORTANT INFRASTRUCTURE

9.1 It may aid stability and certainty if account is taken of the development of the European Market Infrastructure Regulation ("EMIR") as part of the development of these proposals because further legislative changes as a result of EMIR are likely to be required in the future. Resolution powers for Recognised Clearing Houses ("RCH") also require consideration in the context of these proposals.

9.2 The FCA, which will be the relevant regulator for Recognised Investment Exchanges ("RIE"), is obviously subject to the general duties in section 1B of FSMA as well as the provisions on consultation in section 1H of FSMA and the regulatory principles in section 3B of FSMA. These provisions would apply equally to the FCA's functions in relation to RIEs. The Bank of England is not subject to equivalent provisions in respect of its role as the relevant regulator of RCHs. It would appear that the Bank of England's financial stability objective will be the overriding objective in relation to RCHs. However, this will result in a difference between the regulatory framework for RIEs and RCHs (for example, the FCA's "efficiency and choice objective" specifically refers to the promotion of efficiency and choice in relation to the services provided by an RIE however, there is no similar provision in relation to RCHs).