



Association for Financial Markets in Europe Response

HM Treasury's Consultative Document

A new approach to financial regulation: judgement, focus and stability

1. Introduction

The Association for Financial Markets in Europe (AFME)¹ welcomes the opportunity to respond to HM Treasury's Consultative Document "A new approach to financial regulation: judgement, focus and stability."

AFME recognises the failures of, and the Governments' commitment to reforming, the UK tripartite system and believes, in principle, that the model set out in the HM Treasury consultation document (conduc) should deliver effective regulation for both consumers and markets. We welcome, in particular, the establishment of a body with specific responsibility for macro-prudential regulation and the focus on judgement-led regulation.

However, for a regime with multiple, judgement-led, regulatory authorities to function effectively, the precise design of the framework will be crucial to its success. The new framework, as set out in the conduc, raises a number of questions and practical concerns and greater clarity is needed in some areas to understand fully the proposals. We believe, therefore, that significant further thought will need to be given to resolving the potential problems proposed by the new structure; AFME stands ready to work with HM Treasury to help "ensure we get the detailed design right."² We are grateful to the HM Treasury Financial Regulation Strategy Team for meeting with AFME members to receive feedback on the proposals and to help clarify our understanding in relation to specific areas of the conduc.

¹ AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

² Speech by The Financial Secretary to the Treasury, Mark Hoban MP, at the London Stock Exchange, 26 July 2010

2. Executive summary

We set out in Section 4 below our responses to the questions raised in the condoc and our further thoughts on wider aspects of the new framework, with particular focus on their potential impact on firms, markets and wholesale financial services business in London.

In sum, our main areas of concern are around ensuring:

- the new regulatory authorities have appropriate objectives, roles and responsibilities and are subject to the right levels of accountability and transparency;
- the current, robust regulation of markets and the expertise of the Financial Services Authority's (FSA's) Markets Division are not diluted in the new framework (including by the proposed fragmentation of primary and secondary market regulation);
- the framework delivers clear, efficient and effective regulation (e.g. by ensuring the scope of the Prudential Regulatory Authority (PRA) and the Consumer Protection and Markets Authority (CPMA) dovetail in legislation and in practice and by creating a shared services function to perform regulatory processes and provide IT, data warehousing, HR and finance on behalf of the PRA and CPMA);
- the continued effectiveness of International and Europe engagement – both at policy formation and the negotiation stages – and a strong, credible and coherent representation for the UK.

With respect to the last bullet point, and as an over-arching comment, we are conscious of the need for the UK reforms to be considered in the context of the reforms taking place at both an European Union (EU) and an international level. It is crucial that the UK maintains a strong, credible and coherent voice in the EU and internationally (e.g. on the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision) and continues to help shape regulatory developments e.g. in negotiation of directives, setting technical standards and in seconding policy experts to the new European Supervisory Authorities (ESA).

The new UK framework will clearly not mirror the ESAs: for example, under the proposals both the Bank and the CPMA will have responsibility for regulating market infrastructure but only the CPMA will have a seat on ESMA. The optimum interaction of the UK regulatory structure with the new EU bodies – both at a strategic and operational level – needs to be resolved at an early stage in the development of the new framework to ensure that the UK – and in particular the CPMA Markets Division – has sufficient heft and influence.

The FSA's International Division provides currently: *“a centre of excellence for international stakeholder management and analysis....delivered by enhancing our support for representatives on key international committees, strengthening our relationships with key stakeholders required to deliver FSA international strategy and improving our development, implementation and co-ordination of policy.”*³ It will be crucial to ensure that the work of this division is not diluted and that a similar, operational-level, support function is available to manage the UK's international and EU engagement and to co-ordinate within the UK regulatory framework e.g. by ensuring that the right policy experts are involved on committees and working groups and that delegations, particularly to ESMA meetings, include appropriate (albeit non-voting) experts from regulatory authorities that do not formally represent the UK.

Finally, whilst we appreciate that the transitional arrangements will largely be a matter for the FSA, given the time it will take for the new UK financial regulatory structure to be put into place, strenuous efforts will be needed to retain high quality staff and ensure the continuity of expertise within current FSA divisions. For the CPMA, the appointment of high calibre individuals to the Chief Executive and Managing Director posts must be an early priority, if, amongst other things, the CPMA is not to be seen as having a lesser role than the PRA..

We are aware, from reviewing the FSA's (now publically available) written evidence to the Treasury Committee inquiry into financial regulation, that the FSA has identified and is taking steps to mitigate risks associated with transitioning the regulator to the new structure. We assume that HM Treasury will be monitoring these significant risks and any impact on UK financial services (e.g. the FSA's expected reduction its ability to influence developments at an EU level due to pressures on senior management time). We also note that the FSA will use lessons learnt from moving to a shadow operating structure in early 2011 to “modify operational aspects of the new approach before its formal launch in 2012.” We assume that to the extent that changes are needed to primary or secondary legislation, HM Treasury will be involved in the feedback loop.

3. General Comments

AFME believes that key principles for a new regulatory framework should include:

- clarity;
- efficiency; and
- effectiveness.

Clarity: it will be important to ensure that firms and groups which are regulated by both the PRA and CPMA have clarity and certainty with respect to the requirements

³ FSA website

they are subject to and how their duties should be discharged. Conversely, individual regulatory authorities will need to have a clear and complete overview of jointly regulated firms and groups. We believe that to deliver clarity, it will be essential for firms to have a lead regulator, to ensure one point of responsibility and one conduit for notifications etc. For example where a firm is under a duty to notify its regulators, it should be able to submit a notification to its lead regulator, for example, the PRA, and, by so doing, discharge its responsibility to notify its other regulator (for example, the CPMA). In addition, the application of the PRA and CPMA rulebooks must dovetail for jointly regulated firms; in this regard, we believe that high level, over-arching standards such as the Threshold Conditions (COND) and the Senior Management Systems and Controls (SYSC) and also areas of the FSA Handbook such as regulatory processes and the Client Assets Sourcebook should be maintained as a common rulebook.

As discussed in Section 1 above, clarity is also needed in respect of the UK's EU and international engagement.

Efficiency: the precise detail of the legal framework, the detailed operating procedures put in place by the regulators and the degree to which co-ordination can be achieved are key to ensuring an efficient system and we look forward to reviewing the draft legislation early next year. As a guiding principle, however, firms should not be faced with unnecessarily complex or duplicative regulatory or administrative processes e.g. applications for authorisation and approval determined by two regulators, uncoordinated supervisory visits, duplicative reporting requirements. The framework, therefore, needs to strike an appropriate balance between co-ordination and independence of regulatory bodies.

To facilitate co-ordination:

- the FPC, PRA and CPMA should be required to recognise each others objectives unless to do so would be prejudicial to their own objectives;
- a shared services function should be established to provide a common 'back office' for both the PRA and CPMA and, in particular, perform regulatory processes and provide IT, data warehousing, HR and finance for both authorities'; and
- there should be high-level co-ordination of policy setting and operational level co-ordination of policy interpretations.

Effectiveness: around the world a number of different regulatory models failed to detect, prevent and/or manage the crises; we, therefore, need a regulatory system that is effective. Effectiveness, however, depends not just on getting the precise design of the framework right but also on having high calibre senior management to direct the new bodies; appropriately skilled and experienced staff to identify risks, make sound decisions concerning firms; and on the quality of the data on which regulators base their judgments. It is vital that the new regulatory bodies are given

the flexibility to recruit and/or retain the right staff and that there is a standardised framework for data, including its collection and warehousing.

4. Detailed comments

4.1. The Bank of England and Financial Policy Committee (FPC)

AFME welcomes the creation of a body with specific responsibility for macro-prudential regulation and agrees that it is most appropriate to establish the FPC within the Bank of England (the Bank), thereby leveraging from the Bank's existing analytical and economics capabilities and financial stability experience.

Membership, accountability and transparency

The model chosen, with macro and micro-prudential regulation being brought within the overall responsibility of the Bank, will, inevitably result in a concentration of power within the Bank. Our concern is not the concentration per se but whether there are sufficient checks and balances; in particular, transparency and proper accountability to Government and Parliament.

Given that the Governor of the Bank will also chair the Monetary Policy Committee (MPC), the FPC and the Prudential Regulatory Authority and be responsible for the Special Resolution Unit (SRU) within the Bank, we have concerns, in principle, over the perceived independence of the Governor. Given the demanding nature of the Governor's role going forward, the Bank's senior management team will clearly be critical in providing support for the additional responsibilities. We believe that further consideration should be given to the responsibilities of the Governor and, notwithstanding the check provided by the majority of non-executive directors on the PRA Board (c.f. paragraph 3.32 of the condoc), any measures that could be come into effect when a conflict is perceived between specific roles.

We believe that the accountabilities for the FPC and PRA outlined in the condoc – particularly the Governor's proposed six-monthly briefing of the Chancellor – are less onerous than might otherwise be desirable given the power to be vested in the Bank. In designing checks and balances, however, it will be important not to constrain the ability of the Bank to carry out its duties. Possible solutions may include:

- increasing the number of external members of the FPC;
- creation of an independent advisory group of relevant experts;
- increasing the frequency of meetings with the Chancellor to quarterly (in line with the production of statistical data) and involving the CEO of the

PRA (and possibly the CPMA) when macro-prudential tools have been used;

- an annual letter from the Government to the FPC framing financial stability in the context of current economic growth objectives; and
- MPC-style letters from the FPC to the Chancellor when a macro-prudential tool is used, which state the intended outcome and hence can be used to measure effectiveness. As the FPC will not, as we understand it, use macro-prudential tools in relation to individual firms, these letters could be published to mitigate market rumour.

Paragraph 2.43 of the condoc states that: “it will be important to ensure that the external members of the FPC are able to provide sufficient levels of expertise and challenge to the Committee’s deliberations – this will not only include experience of banking, but also other financial sectors such as insurance and investment banking and, of course, macroeconomic expertise.” As proposed currently, 5 out of the 11 members of the FPC are considered external but since this figure includes the CEO of the CPMA, the number of wholly independent external members is arguably 4 (the same as the MPC, which has 9 members in total). We believe, therefore, that external involvement on the FPC should be enhanced by increasing the number of external members and by allowing the FPC to establish a non-executive advisory group of relevant experts (as proposed for the PRA in paragraph 3.35 of the condoc).

Functions

We look forward to further detail, in due course, with respect to how the FPC will work with the PRA (and the CPMA) in the exercise of its macro-prudential tools: for example, will the FPC set ranges and require the PRA to take action or specify the use of a tool; how will macro-prudential regulation be linked to micro-prudential regulation?

We note, incidentally, that although the condoc refers to the FPC’s macro-prudential (counter-cyclical) tools, the tools will actually be applied by PRA at a micro-prudential level. Given that many of the macro-prudential tools are new and their effects at a macro-level are not well understood, it will be important to consider not just the likely effects of a particular tool but also, if used in combination, what effect the tools will have when working together. We wonder, therefore, whether a fixed list of tools enshrined in secondary legislation is appropriate at this stage.

Finally, as markets and financial stability risks are global – and issues of concern to the FPC may not be within their (or the PRA’s) control – there is a need for strong linkages to the new European System Risk Board (ESRB), third country regulators such as the Federal Reserve and the US Financial Oversight Council and international bodies such as the International Monetary Fund and

the Financial Stability Board. We await with interest, details of how the FPC will operate both at a global and a domestic level.

Q1. Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors?

In discussing the objectives of the FPC, we are mindful that financial stability is a far broader concept than macro-prudential regulation and it is interesting to note that EU and International bodies differ in respect of whether their primary responsibility is financial stability or macro-prudential regulation as a contributor to financial stability. AFME's newly formed Macro-Prudential Working Group would be pleased to meet with HM Treasury to discuss the FPC's financial stability and macro-prudential roles and macro-economic tools in more detail.

Turning to Q1, we are concerned that a single, unconstrained, objective for financial stability, which, in itself, is difficult to quantify and measure, could lead the FPC to take a narrow and overly risk adverse approach to stability which might impact negatively on economic growth and other social factors. In particular, it will be important for the FPC to assess, before using its macro-prudential tools, the likely impacts of the tools on wider socio-economic factors, which could, in turn, impact negatively on financial stability. We note in this regard that the mission and objectives of the new European Systemic Risk Board (ESRB) is to:

“...be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress, and contribute to a smooth functioning on the internal market and thereby ensure a *sustainable contribution of the financial sector to economic growth* [our emphasis].”⁴

Paragraph 2.2.4 of the condoc, however, states that: “Within the Bank’s overall financial stability remit, the objective of the FPC will be to protect financial stability by:

- improving the resilience of the financial system by identifying and addressing aggregate risks and vulnerabilities across the system; and
- enhancing macroeconomic stability by addressing imbalances through the financial system, e.g. by damping the credit cycle”

⁴ Article 3 of the Proposal for a regulation of the European Parliament and Council on European Union macro-prudential oversight of the financial system and establishing a European System Risk Board (dated 14 September 2010)

Given the importance of balancing financial stability with economic growth and other macro-economic factors (including but not limited to international competitiveness), we consider that the FPC should have a single over-arching objective that reflects the multifaceted nature of its roles and responsibilities, even if the inter-relationships are complex. We believe that this objective should be comparable to that of the ESRB.

It will be important to amplify the FPC's objective (c/f sections 3 to 6 of the Financial Services and Markets Act (FSMA)), so that the FPC's performance can be more easily accountable to Parliament. For example, by reference to the scope of the risks the FPC is responsible for identifying, monitoring and addressing.

Q2. If you support the idea of secondary factors, what types of factors should be applied to the FPC?

As discussed above, we believe that the FPC should have a single over-arching objective, which is comparable that of the ESRB.

However, to seek to ensure cohesion within the regulatory framework, the FPC's macro-prudential objective should be linked formally to the PRA's (and arguably the CPMA's) micro-prudential regulatory objectives. As is also discussed in response to Q4 below, we believe that each regulatory body should be required to recognise the other's objectives (and at an operational level, decisions), unless to do so would conflict with their own objectives (see also our responses to Q4 and Q10 below, which also refer).

In addition, given the global nature of the UK's markets and while recognising that this forms an intrinsic part of a macro-prudential regulator's role, the FPC could have, as a secondary objective, cooperation and information sharing (in the aggregate) with relevant international and EU bodies such as the ESRB.

Q3. How should these factors be formulated in legislation – for example, as a list of 'have regards' as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance?

We believe that factors not included in the over-arching primary objective should be enshrined in legislation as secondary statutory objectives rather than a list of factors to which the FPC is required to "have regard" but may then give insufficient weight. We believe that secondary objectives would provide more accountability to Parliament, since it is difficult, ex post, to demonstrate whether or not a regulatory authority had 'regard' to a factor.

However, we believe that there should be a formal over-ride which provides that, in the event of a conflict between objectives or when taking urgent action to prevent or manage a crisis, primacy is given to the primary objective.

4.2. The Prudential regulation authority (PRA)

AFME welcomes the establishment of the PRA and supports a more judgement-led approach to regulation. However, the success of more judgement-led regulation will ultimately rest on the quality and competence of the staff that take individual, firm-specific decisions and the checks and balances that exist to deliver proportional and fair outcomes. In particular, as discussed in our response to Q6, to ensure consistency and fairness, the PRA will need to have streamlined and clearly articulated procedures, which are transparent, provide reasons for a decision and give firms wishing to discuss and possibly challenge a decision a fair hearing.

Objectives

As discussed in response to Q1 above, the PRA, CPMA and FPC should have clear objectives - where possible auditable and accountable to Parliament - that reflect fully the multifaceted nature of their roles, even if the inter-relationships are complex. In particular, as growth in the financial markets will aid economic recovery and offer better choice and availability to consumers, we believe strongly that the new authorities should have, as one of their primary objectives, due regard to the UK's competitiveness as an international financial centre and how it may be enhanced by effective regulation.

As HM Treasury recognises, it is also vital that the scope and objectives of the PRA and the CPMA are designed so as to avoid regulatory overlap and regulatory "underlap". We comment further in respect of Q4 below on the proposed objectives of the authorities; in our view though, it is essential that the each authority is required to recognise the other's objectives (and, at an operational level, decisions) unless to do so would conflict with their own objectives.

Scope

We note that the PRA will be responsible for "all firms who are subject to significant prudential regulation." However, we believe that the current proposal, under which the PRA would be responsible for the "authorisation, regulation and day-to-day supervision" of specific regulated activities - namely, "taking deposits", dealing in investments as principal and effecting and carrying our contracts of insurance - will result in significant, unintended consequences, including:

- increasing the number (and types) of firms to be regulated by the PRA: for example, by bringing within scope any firm with a Part IV permission that includes dealing in investments as principal, regardless of whether the firm undertakes that activity or, if they do so, the scale of the business;
- adding unnecessary complexity to the vital gate keeping, authorisation and approvals (approved persons) processes by dividing the authorisation of wholesale firms' trading activities and the approval of individuals to perform certain controlled functions – for example, a significant influence function that involves the supervision of a trading desk that deal in equities as agent and in listed equity derivatives as principal - between the PRA and the CPMA; and,
- causing wholesale firms' trading-related systems and controls to be subject to regulation and supervision by both the PRA and the CPMA.

We concur that reference to specific activities, rather than types of firm, forms a sensible starting point from which to define the PRA's scope (i.e. by determining which firms are, in principle, subject to prudential regulation by the PRA as opposed to the CPMA). However, it will be important to narrow the definition of the PRA's scope to enable it to focus its resources on those firms that actually have complex prudential regulatory requirements, the supervision of which requires the exercise of judgement.

In relation to investment firms, HM Treasury might wish to consider:

- using the Markets in Financial Instruments Directive (MiFID) investment activity of “dealing on own account” - instead of the Regulated Activities Order regulated activity of “dealing in investments as principal” - to define the scope of the PRA. As HM Treasury will be aware, “dealing on own account” (Section A, Annex I to MiFID), has a narrower definition than dealing in investments as principal. In particular, dealing on own account does not include the significant number of derivative brokers that are required by exchange rules to trade on a ‘matched’ basis and whose Part IV permission to deal in investments as principal contains a “matched principal basis only” limitation (defined in the FSA Register as “Unable to hold financial instruments for own account unless it meets the “matched principal exemption conditions” in the FSA's Glossary of defined expressions used in the FSA's Handbook.”) The following extract from the FSA's Perimeter Guidance Manual (PER 13.3) refers:

“Q16. What is dealing on own account? (A3 and article 4.1(6))

Dealing on own account is trading against proprietary capital resulting in the conclusion of transactions in one or more MiFID financial instruments. In most cases, if you were a firm who was dealing for own

account under the ISD, the FSA would expect you to be dealing on own account for the purposes of MiFID if you continue to perform the same activities.

Dealing on own account involves position-taking which includes proprietary trading and positions arising from market-making. It can also include positions arising from client servicing, for example where a firm acts as a systematic internaliser or executes an order by taking a market or 'unmatched principal' position on its books.

Dealing on own account may be relevant to firms with a dealing in investments as principal permission in relation to MiFID financial instruments, but only where they trade financial instruments on a regular basis for their own account, as part of their MiFID business. ..."

- applying a secondary test such as excluding from PRA regulation 'limited activity' firms as defined under BIPRU 1.1.11R (i.e. a CAD investment firm which deals on own account only for the purpose of fulfilling or executing a client order or to in order to gain entrance to a clearing and settlement system or a recognised investment exchange when acting in an agency capacity or executing a client order)

Co-ordination with the CPMA

As HM Treasury is aware, some misunderstandings have arisen with respect to whether giving responsibility to the PRA for the "authorisation, regulation and day-to-day supervision" of specific regulated activities – particularly dealing in investments as principal - means that the CPMA will have no role in respect of these activities. As we understand it, the CPMA will regulate the conduct of a firm when dealing in investments as principal (and carrying on all other regulated activities) while the PRA will have prudential regulatory oversight over dealing in investments as principal (and the other regulated activities within its scope), due to the risk it poses to a firm's safety and soundness.

Although the PRA will be a micro-prudential regulator and the CPMA a business conduct regulator, as discussed above, given the interrelationship between prudential risk and business conduct risk (which often cannot be separately distinguished), there will be no bright line between the regulators' scope for jointly regulated firms, particularly in areas such as systems and controls where the same set of controls may have both safety and soundness and conduct implications. We believe, therefore, that firms (and groups) that are regulated by the PRA and the CPMA should have a lead regulator, whose systems and controls requirements should take precedence.

In addition, if the PRA is to be given responsibility for authorisation of dealing in investments as principal and the approvals of approved persons whose controlled functions relate to this regulated activity, we believe strongly – as discussed in response to Q5 below - that a shared services function should

process applications for authorisation, approval (of approved persons) and carry out other regulatory processes on behalf of the authorities.

It will also be important to have a carefully drafted Memorandum of Understanding (MOU) between the authorities, setting out agreements on, amongst other things, co-ordination of supervision and enforcement, policy formation and consistency of interpretations/decisions. AFME would be pleased to contribute towards the drafting and/or review of the MOU. A practical operating framework will also be needed to ensure that the new framework delivers, amongst other things:

- efficient, shared, processes for authorisation, approval and other regulatory processes;
- co-ordinated and consistent supervision;
- timely and appropriate exchange of information through information gateways;
- co-ordinated reporting and data requirements (including an overarching data integrity and standards programme and data warehousing that facilitates supervisory analysis without placing disproportionate burdens on firms); and
- clarity with respect to respective enforcement functions (and no risk of double jeopardy).

To provide for co-ordination between the PRA and the CPMA, HM Treasury should consider, to the extent it has not done so already, effective mechanism used in other ‘twin peaks’ regulatory systems such France and the Netherlands (see Annex 1 to this response, which gives an overview of the approach, in principle, to regulatory coordination in the Netherlands). We also believe that HM Treasury should establish a strong coordinating mechanism and method of resolving conflicts (c.f. the Joint Committee of the European Supervisory Authorities which will “settle cross sectoral disagreements that may arise between one or more competent authorities...”⁵).

Enforcement

We note from paragraph 3.20 of the condoc that the PRA will be given responsibility for enforcement of compliance with its rules, which we support. However, whilst the condoc makes reference to the CPMA’s enforcement tools, there is no similar discussion in relation to the PRA. To ensure consistency, both the PRA and the CPMA should have the same enforcement powers and toolkits and operate under the same procedures in relation to enforcement of their regulatory own requirements. Clarity is also needed in respect of responsibility for enforcing FSMA offences including ‘unauthorized dealing’ (breach of the ‘general prohibition’ in section 19 of FSMA).

5 Article 11a of the above

Q4. The Government welcomes respondents' views on:

- **whether the PRA should have regard to the primary objectives of the CPMA and FPC;**

To seek to ensure cohesion within the regulatory framework, we believe that both the PRA and the CPMA should be required, formally to recognise the other's objectives (and, at an operational level, decisions), unless to do so would conflict with their own objectives.

In addition, since all the authorities should have financial stability as an objective, the PRA and CPMA could also be required formally to recognise the primary financial stability objectives of the FPC. We also believe that the micro-prudential objectives of the PRA and CPMA should be linked to the FPC's macro-prudential objectives, given that the PRA and the CPMA will be implementing the FPC's decisions.

- **whether some or all of the principles for good regulation currently set out in section 2 of FSMA, particularly those relating to good regulatory practice, should be retained for the PRA;**

We see no reason why the PRA should not be subject to the principles of good regulation, as currently set out in section 2 of FSMA: namely:

- efficiency and economy;
- role of management;
- proportionality; innovation;
- international character; and
- competition

We believe that these principles should be enshrined in legislation as primary objectives rather than factors to which the PRA should "have regard". However, given that the PRA may be required to give effect to decisions *in extremis*, the principles could be subject to an emergency override.

With respect to competition (section 2(3)(f) of FSMA) we believe that an important debate needs to take place on the respective roles of financial services regulators and the Office of Fair Trading (OFT) [or a merged OFT and Competition Commission]; the important role of the latter in scrutinising the rules of financial services regulators, under section 160 of FSMA, should continue.

- **whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained;**

Before responding to this question, it is important to consider the wider meaning of the requirements and not equate 'innovation' with 'risk' and 'competitiveness' with 'light touch regulation'.

Section 2(3)(d) of FSMA refers to: "the desirability of facilitating innovation in connection with regulated activities." This is one of three "pro-competition" principles that were introduced following the interim findings of the Cruickshank Report on "Competition in UK Banking"⁶. For the FSA, as their website explains: "This involves, for example allowing scope, where appropriate, for different means of compliance so as not to unduly restrict market participants from launching new financial products and services." In short, effectively regulated innovation creates greater choice for consumers.

Section 2(3)(e) of FSMA refers to: "the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom." To comply with this requirement the FSA, as their website explains: "...take into account the international aspects of much financial business and the competitive position of the UK. This involves co-operating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively." In short, competitiveness and the international nature of financial markets are intrinsically linked and rather than reducing standards to attract new entrants, this principle should focus a regulator on creating a regulatory regime that is consistent for globally active firms and attractive (to new entrants and new capital) because of its effective and proportionate regulation.

It is also of note that recital 9aa of the Proposal for a regulation of the European Parliament and the Council establishing a European Banking Authority (dated 14 September 2010) states that: "The authority should take due account of the impact of its activities on competition and innovation within the internal market, the Union's global competitiveness, financial inclusion and the Union's new strategy for jobs and growth."

In sum, we believe it is important for the UK economy that international competitiveness, innovation and economic growth should be included as objectives for both the PRA and the CPMA; there should also be consistency with the ESAs in this regard.

- **whether there are any additional broader public interest considerations to which the PRA should have regard.**

We have no comments on this question at this stage.

⁶ See Government response dated August 2000

Q5. Is the model proposed in paragraph 3.16 – with each authority responsible for all decisions within their remit subject to financial stability considerations – appropriate, or would an integrated model (for example, giving one authority responsibility for authorisation and removal of permissions) be preferable?

Given the difficulties, as discussed above, in creating a bright line between the scope of the PRA and the CPMA for jointly regulated firms, we believe that the model proposed in paragraph 3.16 of the condoc will be subject to significant operational difficulties. In particular, in the capital markets, the model would result in both the PRA and the CPMA determining applications for Part IV permission and applications for approval for individuals to perform significant influence functions that involve the supervision of agency and principal business.

Instead, we strongly support the establishment of a shared services function that would provide a common ‘back office’ for both the PRA and CPMA and, in particular, perform regulatory processes and providing IT, data collection and warehousing, HR and finance for both authorities. As well as creating a single contact point in respect of applicants for authorisation and approval, a shared services function could screen applications on a case by case basis to identify whether the application should be determined by specialists from the PRA and/or the CPMA e.g. by considering whether an application for approval poses any prudential risks. A common back office would also provide considerable synergies, assist with information flows and help avoid unnecessary divergence between the authorities at an operational level.

We also believe that, instead of creating duplicate and potentially divergent technical units in the PRA and CPMA, ‘centres of excellence’ should be established for the regulatory system as a whole. For example, given that client assets (including their protection and speedy return to customers) must continue to be a key focus in the new framework, the FSA’s new Client Assets Sector team should not be fragmented across the PRA and CPMA; instead we believe that it should form part of the PRA but act as a centre of excellence (i.e. resource) for the CPMA, thereby providing a single source of interpretation (for a single set of rules) and expertise.

Q6. Is the approach outlined in paragraph 3.17 to 3.23 for transfer of regulatory functions and rule making sufficient to enable the PRA to take a more risk-based, judgement-focussed approach to supervision?

We welcome the statement, in paragraph 3.17 of the condoc, that the Government goal “is that the legal framework for the PRA should underpin a more informed and judgemental approach to regulation.” We see this as an expression of the risk-based type of regulator that the FSA was seeking to

become and believe that the proposals could deliver, if the PRA has sufficiently experienced supervisors to understand and appropriately challenge firms, an effective check against a firm becoming an unacceptable risk to the financial system.

With the exception of functions relating to regulatory processes, which we discuss in Q5 above, the measure set out in the condoc appear sensible and we look forward to further detail. However, ultimately, the success or failure of a more-judgement led regulator will depend on the quality of its staff (who need to be as good, if not better than the firms they regulate) and on the quality of the data on which they base their judgments. The PRA and the CPMA must, therefore, have the flexibility – both in terms of remuneration and career opportunities – to recruit (and retain) high calibre individuals from the industry and consideration should be given to a standardised framework for data and its collection and warehousing.

The PRA will also need arrangements to ensure that its firm-specific decisions are subject to review and challenge internally, to ensure that all appropriate factors have been considered (e.g. to provide for a specialist review of evidence, checks for consistency with peers) and stated procedures have been followed. These supervisory processes need to be open and transparent and, ordinarily (unless the PRA has reasonable grounds to suspect fraud or has other serious concerns with respect to management), provide for an informed dialogue between firms and their supervisors at an early opportunity. Where decision are significant, we would expect that the formal checks and balances within the FSMA with respect to, amongst other things, supervisory, warning and decision notes, would apply.

There should also be a formal mechanism for firms wishing to challenge the decisions of supervisors. As a first stage, we would envisage an RDC type committee, with senior practitioner and possibly academic involvement followed by the existing right of appeal to the Financial Services and Markets Tribunal

Q7. Are safeguards on the PRA's rule-making function required?

We see no reason why all the FSMA mechanisms around the rule-making process – notably the section 155 of FSMA requirement to consult and perform a cost-benefit analysis – should not apply to the PRA in relation to its rule-making function. We regard these mechanisms as of fundamental importance and welcome the statement in paragraph 4.20 of the condoc that they are to apply to the CPMA; we regard these safeguards as of equal (and, arguably, greater) importance to a judgement-led regulator which will be proceeding in the context of a framework of prudential rules.

Q8. If safeguards are required, how should the current FSMA safeguards be streamlined?

We believe that FSMA (for example section 155(7) of FSMA) currently provides the FSA with flexibility to make rules in extremis. The only other area where we believe there could be streamlining is in relation to the copy-out of (directly applicable) EU Regulations, where an exception from the duty to perform a cost-benefit analysis could be provided; perhaps requiring instead an impact assessment?

Q9. The Government welcomes views on the measures proposed in paragraphs 3.28 to 3.41, which are designed to ensure that the operation of the PRA is transparent, operationally independent and accountable.

We welcome the Government's:

- intention to "legislate to make the PRA subject to audit by the National Audit Office (NAO)" (paragraph 3.39 of the condoc);
- expectation that the PRA representatives will agree to appear before the Treasury Select Committee (paragraph 3.40 of the condoc); and
- proposal that CPMA will be responsible for collecting all levies.

We note that the PRA will "as a starting point...be required to produce an annual report which the Treasury will lay before Parliament." We believe that this annual report should be accompanied by a business plan (c.f. the FSA's Business Plan) for the forthcoming year, which will allow Parliament an opportunity to look at past performance and planned future work. The business plan should, in our view, include a detailed work programme, detailing non-routine work streams, which has been previously consulted upon, and be linked to a Financial Risk Outlook (produced by the FPC with sector-specific input from the PRA and CPMA).

We also note from paragraph 3.37 of the condoc that "the Government will seek to supplement this basic requirement [an annual report] with further practical accountability mechanisms which will reflect the significant public responsibilities with which the Bank is being provided." We look forward to further details.

However, we believe that the PRA should be subject to the same accountability mechanisms as proposed for the CPMA (paragraph 4.36 of the condoc), including the extension of the FSMA consultative panels to the PRA. We also believe that the scope of the Complaints Commissioner should be extended to the PRA.

Being a judgement-led regulator (as discussed in our response to Q6), it will also be critical for the PRA to embed transparency, accountability and consistency at lower levels of decision making and interaction with firms.

4.3. Consumer protection and markets authority (CPMA)

Objectives

As discussed in relation to the PRA, given its multiple roles, the CPMA will need a set of primary objectives – rather than a single objective – to reflect the multifaceted, and possibly competing, nature of its responsibilities. Our response to Q1 below refers.

Structure

The structure of the CPMA will clearly need to reflect the wide range of non-prudential functions undertaken currently by the FSA, including the regulation of retail and wholesale firms. We agree that, as stated in paragraph 5.10 of the condoc, given “the differences between retail financial services conduct and wholesale markets conduct issues, responsibility for all market conduct regulation will be located within an operationally distinct division of the CPMA.”

In January 2002, the external facing structure of the FSA comprised a:

- *Consumer, Investments and Insurance Directorate*, which included a Consumer Division (with a dedicated Consumer Protection Department);
- *Deposit Takers and Markets Directorate*, which included ‘Markets and Exchanges’ and ‘Major Financial Groups’; and a
- *Regulatory Processes & Risk Directorate*.

The CPMA should, in our view, comprise two (or possibly more) divisions – a Consumer Division and a Markets Division – each of which is headed by high calibre deputy CEO who (as is the case with the FSA’s Managing Directors) is a member of the main CPMA Board. Wholesale investment firms should be supervised by the Markets Division and retail firms by the Consumer Division. We believe that such an “operationally distinct” structure – with an independent and strong Markets Division – is necessary to ensure that an appropriately balanced, risk-focused and proportionate approach is taken to the supervision of retail and wholesale firms.

Enforcement

We welcome the statement, in paragraph 4.26 of the condoc, that the CPMA will have a separate market enforcement function within the Markets Division although clearly this will need to form part of the CPMA's wider enforcement capability. We await the forthcoming consultation on a proposed Economic Crime Agency; however, at this stage we believe that ensuring credible and effective enforcement within the CPMA is more important than moving powers to a new agency. In particular, any proposals adversely affecting the CPMA's ability to pursue market abuse investigation using either criminal or civil powers will need careful consideration.

Consumer protection

As a trade association representing the wholesale capital markets, AFME will not be commenting in detail on consumer protection. However, we do wish to highlight a number of issues.

Firstly, there is general concern that the CPMA's "strong consumer champion" role (paragraph 4.3 of the condoc) will not sit comfortable with the role of a regulator; the latter needing to be neutral in its dealings with regulated firms and consumers and the former suggesting a body which will fight for consumer rights or act as a consumer advocate. We consider that reference in paragraph 1.21 of the condoc, to the CPMA protecting consumers "through a strong consumer division" is more a more helpful description of the CPMA's consumer protection role.

Secondly, we would note that the FSA's consumer protection objective, as set out in section 5 of FSMA, sets realistic expectations with respect to the FSA's responsibilities and the responsibilities of consumers; this is important to avoid challenge to the regulator:

"A number of complainants in their submissions to the Commissioner have tried to rely upon a limited construction of the statutory objectives or aims of the FSA as contained in FSMA. The most common construction argued relates to "consumers". For example this relates to "helping retail consumers achieve a fair deal". A number of consumers have tried to argue, erroneously in the Commissioner's view, that this relates to consumers in the singular sense, that is, if as an individual, they have suffered a loss then logically the FSA has failed its statutory objectives. This is not the case. Sometimes the FSA is approached by a firm who submits a plan of action to the FSA that it proposes to take due to, for example, difficult market conditions. This might relate to a large population of different class of consumers and changes in the firm's treatment of such consumers which may lead to an unavoidable loss to some consumers. The FSA will then make its position clear bearing in mind its statutory aims and objectives and as a result of this some classes of consumers may suffer loss. However the FSA has not failed in its aims or objectives as it has made its decision based on its appraisal of the situation as a whole in relation to the different classes of consumer. Losses possibly suffered by one class of consumer is probably a better situation than losses inevitably being suffered by all classes of consumer." Complaints Commissioner – 2009/10 report

We believe that the CPMA's consumer objective should reflect section 5 of FSMA (protection of consumers).

Passporting

The CPMA, as the conduct regulator, will, we assume, be responsible for inward and outward passporting under the EU single market directives; its duties including receiving notifications from incoming EEA firms wishing to establish branches in, or provide services into, the UK under a single market directive. We also assume that the passporting unit would be located in a Markets Division with the range of functions that we propose above. We look forward to further detail with respect to passporting in the next consultation.

Q10. The Government welcomes respondents' views on:

- **whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;**

We note that the objective of the European Securities and Markets Authority (ESMA) will be to:

“protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses.”⁷

Given the CPMA's role as the UK markets authority, we believe that the CPMA should, as a minimum, be required to recognise the FPC's financial stability statutory objective; arguably, though, the CPMA should have its own, markets focus, financial stability objective. In addition, as discussed in response to Q4, we believe that both the PRA and the CPMA should be required, formally to recognise the other's objectives (and, at an operational level, decisions), unless to do so would conflict with their own objectives.

We look forward to greater detail on how the FPC will work with the CPMA e.g. on issues that involve the stability of markets.

- **whether some or all of the principles for good regulation currently set out in section 2 of FSMA should be retained for the CPMA, and if so, which;**

See our response to Q4 above; we believe that the principles of good regulation are an important discipline for regulators and assist consumers by avoiding disproportionate and costly regulation.

⁷ Article 1(4) of the Proposal for a regulation of the European Parliament and the Council establishing a European Securities and Markets Authority dated 14 September 2010

- **whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and**

Yes; see our response to Q4 above.

- **whether there are any additional broader public interest considerations to which the CPMA should have regard.**

We have no comments on this question at this stage.

Q11. Are the accountability mechanisms proposed for the CPMA appropriate and sufficient for its role as an independent conduct regulator?

We welcome the more detailed accountability mechanisms proposed for the CPMA in paragraph 4.36 of the condoc and believe that all accountability mechanisms set out in FSMA should be retained in their entirety.

In addition, as discussed in relation to the PRA, we believe that the annual report should contain a work programme for the forthcoming year, which has been previously been consulted upon, and be linked to a Financial Risk Outlook (produced by the FPC with sector-specific input from the PRA and CPMA).

We also welcome the Government's:

- intention to "legislate to make the CPMA subject to audit by the National Audit Office (NAO)" (paragraph 4.37 of the condoc); and
- expectation that the CPMA representatives will agree to appear before the Treasury Select Committee (paragraph 4.39 of the condoc).

Q12. The Government welcomes views on the role and membership of the three proposed statutory panels for the CPMA.

We welcome and support fully the statements that the CPMA will "retain the two current panels required under FSMA, the Consumer Panel and the Practitioner Panel" and that the "Small Business Practitioner Panel will also be placed on a statutory footing." However, as discussed in relation to the PRA, we believe that the remit of the panels (in particular the Practitioners Panel) should be extended to the PRA so that the panels have an over-arching view of financial regulation; thereby helping to ensure a consistency of approach.

In terms of membership, we believe that consideration should be given as to how the panels could draw more fully upon specialist input in technical areas (for example by the creation of specialist advisory groups – such as a wholesale advisory group - which could be called upon when necessary) and how the nature of their interaction with the regulatory authorities could be enhanced.

Q13. The Government welcomes views on the proposed funding arrangements, in particular, the proposal that the CPMA will be the fee- and levy-collecting body for all regulatory authorities and associated bodies.

We support the proposed funding arrangements. We would not, however, wish to see the costs to firms escalate purely as a result of the establishment of additional regulatory bodies; as discussed in response to Q5, we believe that a "shared services" operating model should be developed (covering IT and other support functions) so as to achieve economies of scale.

We would ask that both the PRA and the CPMA use a common methodology to calculate their fees – to avoid larger firms having to submit different sets of data - as well as a common mechanism for collection. This could be achieved, for example, by the shared services function operating a single budgetary process for both the PRA and the CPMA, which is subject to oversight from the NAO.

Q14. The Government welcomes views on the proposed alternative options for operating models for the FSCS.

Any 'alternative options' for the FSCS must be considered in the light of the EU proposals for an investors' compensation scheme and a deposit guarantee scheme. That said, we continue to believe that there should be one UK scheme with mechanisms to avoid cross subsidy.

4.4. Markets and infrastructure

We welcome the statement, in paragraph 5.1 of the condoc, that: "A key imperative for the new structure...will be a stable and credible framework for market regulation which promotes confidence in the stability, integrity and efficiency of financial markets in the UK." We also welcome HM Treasury's commitment to the CPMA having a strong Markets Division.

It is, however, crucial that the current, robust regulation of markets and the expertise of the FSA's Markets Division are not diluted in the new framework and that, given the changes to EU supervisory arrangements, it is vital that the CPMA has the maximum expertise, authority, resources, and breadth of competence to enable it to exert the necessary influence in respect of directive negotiations etc. Our detailed feedback in respect of the proposals that would fragment market regulation are set out below, however, as an over-arching comment, it will be crucial to have effective co-ordination of EU and International liaison and engagement at an operational level.

Q15. The Government welcomes views on the proposed division of responsibilities for markets and infrastructure regulation.

There is a case, which we recognise, for clearing houses being regulated by the Bank; not least because the failure of the major clearing house would, like the failure of a payment system, have catastrophic consequences. However, given the market trend towards vertically integrated exchanges, we are concerned that the CPMA, who will regulate the exchange and trading platforms, may not have a complete 'front to back' overview of the operations of a vertically integrated market infrastructure provider. The CPMA will also need prompt and full access to information on firms' open positions from clearing houses, in the event of a crisis in the financial markets.

Since close co-operation and free flow of information between the CPMA and the Bank will be vital – particularly given the development of an EU regime for the central clearing of OTC derivatives - we suggest that HM Treasury consider a European model, in which clearing houses are supervised by college made up of central banks and markets authorities (e.g. the Commission Bancaire and the AMF).

It will also be important to ensure that the UK's representation on ESMA in respect of market infrastructure issue – particularly given the developments in the regulation of OTC derivatives – is not diluted, by ensuring effective co-ordination and communication between the Bank and the CPMA Markets Division.

Q16. The Government welcomes views on the possible rationalisation of the FSMA regimes for regulating exchanges, trading platforms and clearing houses.

We look forward to receiving, in due course, further and better particulars on the rationalisation that HM Treasury has in contemplation. In the meantime, we see no benefit in 'rationalisation' of the Part 18 FSMA recognition regime with the Part 4 FSMA authorisation regime since, particularly given their different risk profile and quasi-regulatory role, we do not believe that recognised bodies should be regulated in the same way as authorised firms.

As HM Treasury will be aware, recognised bodies (i.e. recognised investment exchanges and recognised clearing houses) perform important regulatory functions, which help to ensure neutral, efficient and orderly markets, and have a critical role in respect of maintaining confidence in the UK markets. We believe that the recognition regime should remain separate and distinct from the authorisation regime as the recognition requirements enshrine vital requirements to help maintain high standards of market regulation and consumer protection and the UK's reputation as an international centre for capital-raising.

Q17. The Government would welcome views on whether the UKLA should be merged with the FRC, as a first step towards creating a companies regulator under BIS.

We are strongly of the opinion that supervision and enforcement of the primary and secondary markets should not be fragmented. We are unaware of either any market participants who support this proposal or of any EU or major international jurisdiction that separate primary and secondary market regulation.

As the FSA website explains: *“The FSA, when it acts as the competent authority under Part VI of FSMA, is referred to as the UK Listing Authority or UKLA. In this role, the FSA is a securities regulator, focused on the companies which issue the securities traded in financial markets.*

By making and enforcing the Disclosure and Transparency Rules, the Listing Rules and the Prospectus Rules, we aim to protect investors and foster appropriate standards of transparency, conduct, shareholder rights and due diligence”

The regulation of primary and secondary markets is inextricably linked such that a dividing line cannot easily be drawn between regulatory issues that arise in the primary market, in relation to a listing, and those that relate to the secondary market (i.e. the subsequent dealings in the new listing). The need for regulation throughout the lifecycle of a security listed in the UK should be seen as an unbroken continuum from pre-listing vetting, ensuring accurate information is provided to investors, through to established trading in the secondary market; dislocating primary and secondary market regulation will create fault lines that could impact on the supervision of markets, the protection of investors and the fight against financial crime.

The Market Abuse Directive, for example, is implemented in the UK in the FSA’s Code of Market Conduct and the UKLA’s Disclosure and Transparency Rules and a number of the FSA market abuse enforcement cases also involve listing.⁸ Under the article 11 of Directive, however, a Member State may only “designate a single administrative authority competent to ensure that the provisions adopted pursuant to this Directive are applied.”

In relation to leaks inquiries: “Where the UKLA is obliged by an issuer’s non-disclosure to invoke our powers to require an announcement or to suspend an issuer’s securities, we may make ex post enquiries as to whether all parties

⁸ For example, the 2004 FSA enforcement action against Shell Transport and Trading Company (“STT”), Royal Dutch Petroleum Company (“RDP”) and the Royal Dutch/Shell Group of Companies (“Shell”) for “committing market abuse and breaching the listing rules.”

have been sufficiently open and cooperative in their dealings with us to that point and whether there have been any breaches of the FSA's rules.”⁹

The UKLA, as a securities regulator, also has a significant volume of work; for example, it approves prospectuses and listing particulars in respect of listed issuers or issuers who have had securities admitted to trading on a UK regulated market or companies who have made applicable offers of securities to the public in the UK. In January 2010 alone, 93 approved documents are listed on the FSA website. The UKLA also receives notifications of prospectuses that have been approved by a non-UK EU competent authority and passported, under the Prospectus Directive, for the purpose of admitting securities to trading on a UK regulated market.

More detailed considerations in respect of this proposal are included as Annex II to this response.

In sum, moving the UKLA to the Financial Reporting Council (FRC) will create a fault line in the regulation of markets and by so doing will risk impeding market regulation and, in particular, the fight against market abuse. The separation of primary and secondary market regulation would also risk diluting the UK's voice at ESMA. If the UKLA were to be merged with the FRC, it would have to be represented by the (voting) CPMA member; hence the CPMA member might be viewed, by other EU member states (who do not divide primary and secondary market regulation), as a messenger rather than the expert, **which could impact on the negotiation of key directives such as the Transparency Directive.** Moreover, at a higher European level, the proposal to merge the UKLA into the FRC would result in the UK's financial markets being represented by two ministers in Europe (one from the Treasury and one from Department for Business Innovation and Skills). This would, again, be at odds with the approach of other member states and could weaken the UK's voice in Europe further.

Q18. The Government would also welcome views on whether there are other aspects of financial market regulation which could be made more effective by being moved into the proposed new companies regulator.

See our response to Q17 above.

4.5. Crisis management

As an over-arching comment, we believe that greater clarity and detail is needed with respect to the proposals for crisis management. AFME continues to contribute to HM Treasury's work on resolution regimes for investment

⁹ LIST: Issue No. 23 – December 2009

banks and looks forward to providing more detailed input on this important topic as part of the second and more detailed consultation phase.

Q19. Do you have any overall comments on the arrangements for crisis management?

We support the development of clear and effective arrangements for crisis management, which take account of the lessons learnt from recent events. We look forward to further detail on the proposed arrangements in due course.

In the meantime, we note from paragraph 6.10 of the condoc that “the Chancellor will be accountable to Parliament for the authorities’ crisis management strategy.” We assume, therefore, that HM Treasury will be informed whenever there is a ‘crisis’ and will play an appropriately involved role in management (from monitoring to hands-on engagement), regardless of whether or not there might be a decision affecting public funds or international obligations.

In addition, whilst, the failure of a small firm with a large retail customer base may not be defined as a crisis and will not require recourse to public support, we assume that, given the impact on individuals, the Government would wish to, at the least, be kept apprised, for example, with respect to the payment of compensation by the Financial Services Compensation Scheme (FSCS).

We would also make the following observations:

- whilst responsibility for resolution falls to the Bank, as the CPMA supervises exchanges and trading platforms we were surprised to note that the CPMA does not have a crisis management role. We believe that the CPMA should have an active role both in CCP resolution and in respect of the market consequences of a failed investment firm (e.g. in relation to overseeing transfers of open positions);
- as the Governor chairs the PRA, there could be a perceived conflict when the PRA places a firm in the Special Resolution Regime, as the Special Resolution Unit also falls within the Governor’s responsibilities. We believe that this warrants further consideration;
- there appears to be an emphasis on the failure of banks, however, as a future crisis is unlikely to be the same, the arrangements need to ensure that there is a broad range of tools available;
- whilst the Bank will need strong information barriers to avoid conflicts, if the Bank makes a capital injection into a market participant, to what extent could they/should they inform the Markets Division of the CPMA in advance? Again, we believe this warrants further consideration.

Q20. What further powers of heightened supervision should be made available to the PRA and the CPMA, and in particular would there be advantages to mandatory intervention, as described in paragraph 6.17?

We support enhanced clarity about “own initiative variation of permission” (OIVOP) powers and the circumstances in which they might be used by the PRA and CPMA but would not wish to see these powers being used as a routine alternative to enforcement action.

However, changing the trigger points at which a regulator is able to take action before a firm breaches the threshold conditions or mandatory intervention would warrant a detailed review. We look forward to further details of HM Treasury’s proposals (including the rationale for enhancing OIVOP powers) in due course.

Q21. What are your views about changes that may be required to enhance accountability within the SRR, as described in paragraphs 6.21 to 6.24?

Paragraph 6.21 of the condoc states that: “The Government will look at proposals to strengthen the accountability and effectiveness of the authorities in exercising their powers under the SRR, taking account of the regulatory authorities’ new roles”. This is an important issue which warrants careful consideration. Whilst we support the basic premise that the authorities should be accountable, it will be important to ensure that accountability, and the possibility of legal challenge, will not discourage the authorities to use such tools when it is necessary.

In addition, we believe that the position of directors in crisis management situations remains unclear. Our concern is that in a distress situation, a conflict could arise between the objectives of the regulatory bodies responsible for financial stability and protecting depositors and those of the individual directors as senior managers or officers of the company. Such a conflict could give rise to considerable corporate governance concerns as senior management are generally required as a matter of corporate law to act in the interests of the institution while it is solvent, and in the interests of creditors on and following insolvency.

The implementation of wind-down plans necessarily must take effect pre-failure. Powers to force directors to take particular action (such as implementing resolution plans) may place them in conflict with their duties to act in the best interests of the company - particularly where the actions are for the benefit of the financial system as a whole rather than the company. As the law stands today, that conflict could ultimately carry legal liability for the senior management of the institution if their implementation is successfully challenged by shareholders or creditors following a failure of the institution.

Similar concerns arise where crisis management powers are used to disincentivise, or prevent, a board from filing for insolvency.

We would recommend that the review of accountability includes considering statutory reforms that prevent directors from being held personally liable in these situations.

4.6. Impact assessment

Q22. Annex B contains a preliminary impact assessment for the Government's proposals. As set out in that document, the Government welcomes comments from respondents on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.

Members are still considering the preliminary impact assessment. However, given the number of areas in which further and better particulars will be necessary before the real impact can be assessed (e.g. clarity on the number of firms that will be regulated by the PRA), we anticipate providing more detailed input at the next stage of the consultation process.

Regulatory cooperation in the Netherlands: an overview

As HM Treasury may be aware, in the Netherlands the Authority for the Financial Markets (AFM) is responsible for the supervision of conduct of the financial markets while the Dutch Central Bank (DNB) is responsible for the prudential supervision of financial enterprises. Both bodies have responsibility for authorisations. The Netherlands' "one-stop-shop principle" and regulatory cooperation is explained as follows:

The division of tasks between DNB and AFM does not affect the circumstance that both supervisory bodies are active within the same financial sector. Partly in order to prevent an overlap between the two bodies' exercise of their supervisory tasks and to promote an efficient and decisive supervisory system, the Wft [The Financial Supervision Act] provides that, to the extent possible, a single supervisory authority will have decision-making power (one-stop-shop). This means that decisions on applications by financial undertakings for a licence or a waiver may authorisation or exemption may be taken by one supervisory authority.

The financial supervisors set up the (Meldpunt Toezicht Overlap) in April 2003. Supervised institutions can submit complaints to the Bureau about overlaps in operational supervision by these supervisory authorities. On a number of issues the Wft imposes an obligation on DNB and AFM to cooperate (see Sections 1:46 to 1:50 Wft). In addition, DNB and AFM have entered into a new covenant. The Wft also contains rules for cooperation between DNB or AFM and foreign supervisory authorities or the European Commission."

[Extract from: www.dnb.nl/openboek/extern/id/en/all/41-155123.html]

Section 1:46 (1) of the Wft provides that "The supervisors shall collaborate closely with a view to laying down generally binding regulations and policy rules, in order to ensure that these are equivalent wherever possible insofar as they relate to matters that are both subject to prudential supervision and supervision of conduct." These matters include over-arching requirements such as "controlled and sound operations", properness and expertise.

There is also a detailed "covenant" in place between the AFM and DNB, which covers cooperation in data gathering, supervisory visits etc:

"To supplement and elaborate this statutory cooperation, further agreements have been made in the covenant to avoid potential overlap and to ensure that the supervision is carried out efficiently and effectively. Where possible and worthwhile, the supervisors thus make use of the information and expertise available to them (taking account of the relevant statutory provisions on confidentiality) and of the infrastructure available to them for requesting information and data from supervised financial undertakings, pension funds and accountancy organisations. Where necessary and possible, DNB and AFM also cooperate in relation to the formulation of regulations and policy."

[Extract from: www.dnb.nl/openboek/extern/id/en/all/41-158314.html]

With respect to applications for authorisation, the AFM handles applications for investment firms while the Dutch Central Bank handles applications for insurers and credit institutions. Input is then co-ordinated under Section 1:48 of the Wft which provides that:

- *“If the Dutch Central Bank, in processing an application....is required to assess whether the applicant meets the requirements laid down by or pursuant to Part 4, Conduct of Business Supervision of Financial Enterprises, it shall request the opinion of the Authority for the Financial Markets before rendering a decision on such an application.”*
- *“If the Authority for the Financial Markets, in processing an application ... is required to assess whether the applicant meets the requirements laid down by or pursuant to Part 3, Prudential Supervision of Financial Enterprises, it shall request the opinion of the Dutch Central Bank before rendering a decision on such an application.”*

We believe that HM Treasury should, to the extent it has not done so already, consider in detail the strengths and weaknesses of similar “twin peaks” regulatory models and assess whether any existing ‘good practice’ around regulatory cooperation and coordination should be built into the UK framework.

Question 17: more detailed consideration**1 Operational and deal specific reasons for keeping the UKLA within the CPMA****1.1 Operational matters:**

- a) The UKLA's function of monitoring listed companies plays an essential role in linking primary markets' regulation with the market abuse responsibilities that are being transferred to the CPMA. Since both the CPMA and the UKLA will be closely involved with the monitoring of inside information, the UKLA should be kept within the CPMA Markets Division so that information can be easily and effectively shared on a timely basis;
- b) Separation of the UKLA and the CPMA is not effective from an investor protection point of view. As securities are fungible, they can be bought on either the primary or the secondary market. CPMA would, therefore, need to be able to regulate both the primary and secondary markets in order to deliver satisfactory investor protection;
- c) Given that the CPMA will be the market regulator, it is logical for the UKLA to sit within the CPMA in order that the CPMA has a definitive overview of both primary and secondary market activity;
- d) The inter-conditionality between admission to trading on a regulated market and admission to listing represents another case for keeping the UKLA with the CPMA. The CPMA would be required to ensure that the admission to trading requirements are satisfied by the exchanges it supervises, and the regulatory linkage between this requirement and the conduct of the listing regime clearly makes the CPMA the logical home for the UKLA;
- e) The CPMA, as market regulator, would need to also be responsible for primary markets in order to effectively ensure orderly markets. There could be circumstances, for instance, where the regulator would need to suspend trading and/or listing, for example; and
- f) There are close links between financial promotion regulation and the prospectus and public offer regimes, and between the Undertakings for Collective Investment in Transferable Securities ("UCITS") and listing regimes, and both UCITS and financial promotion will be CPMA responsibilities.

1.2 Deal specific issues in relation to splitting the regulation of primary and secondary markets:

- a) **IPOs** - An initial public offering provides the clearest example of a significant risk of “underlap” and a loss of logical synergies if the primary and secondary element of regulation were to be split. Were the UKLA to be merged with the FRC, then the regulation/approval of the prospectus and the listing application would be undertaken by the FRC, whereas all secondary aspects (such as stabilisation and the monitoring of insider dealing) would be within the remit of the CPMA. Numerous of these secondary considerations are so inextricably linked to the consideration of the initial listing that there is no good argument for not keeping the primary and secondary regulation under one regulatory roof. Were the regulator that was responsible for the listing not to pass on information that could have an effect on the secondary market, an adverse impact could be had on the market. Similarly, the ongoing requirements in respect of the secondary market for any security which is proposed to be listed should inspire and have an influence on the disclosure in the initial listing document.
- b) **Rights Issues** – Similar issues arise on a rights issue. Arguably, however, rights issues provide an even clearer example of where joined-up regulation is required. There can be no sensible argument made for having one regulator vetting a rights issue prospectus and the trading of the nil paid rights, independent of the regulator that monitors the already listed shares of the issuer to which the rights relate. Indeed, the issues surrounding the recent proliferation of short selling of the shares of issuers conducting rights issues and the regulatory issues that this often presents further makes the case for having the primary and secondary regulation under the umbrella of one authority.
- c) **Issues of exchangeables/convertibles** – A transaction involving the new listing of an instrument that relates to an already publicly traded security is another important area where having one regulatory body focussed on primary and secondary matters is essential to ensuring an orderly and secure market, particularly in respect of insider trading. If inside information in relation to either the instrument to be admitted or the (already listed) underlying security were being acted on, under a scenario where primary and secondary market responsibilities are split, there is a serious risk of insufficient or untimely information sharing. In such a situation, it would be unlikely that one regulator would know about the activities being monitored by the other.

2 Key differences between the UKLA and the FRC

It is important to consider the different culture and roles of the UKLA and FRC. The FRC is not a “real-time” regulator. Its experience to date has primarily focused on setting standards in respect of reporting and audit functions and the rule writing for the regulation of UK corporate governance. Much of this rule writing is carried out by various policy committees and boards. This should be contrasted with “real time” and more flexible UKLA operations.

The UKLA has a long track record of operational experience and it applies and interprets rules in relation to complex facts and delivers responses/makes rulings in time pressured situations. The UKLA is, therefore, reactive, dynamic and astute and there is a concern that the UKLA would lose its dynamism and responsive approach to complicated listing and market issues if it were merged with the FRC.

It is important to note that the large majority of companies listed in London are not UK companies; these non UK listed companies would, therefore, not fall within the scope of a ‘companies regulator’. Indeed, approximately only six per cent of the securities listed on the Official List are issued by UK corporates. Moreover, a number of issuers whose securities are listed in London are not corporates but supranational and other such quasi-corporate entities, which, similarly, do not fall within the FRC’s remit. This evidence clearly negates any benefits that may be realised by having listing and market responsibilities being brought under the auspices of the company regulator and reinforces the argument for keeping primary and secondary regulation under the control of one body; and a body that is more experienced in assessing complex matters in respect of diverse securities rather than simple rule making in respect of audit, reporting and governance functions of UK corporates.

Another key consideration for the future of market regulation will be the nature of penalties imposed for misconduct; a question which illustrates the significant differences between the remit of the FRC and the UKLA. The primary recourse for the FRC (via the Financial Reporting Review Panel) is via the UK justice system (for example, a court imposed re-statement of accounts). The UKLA, on the other hand, is able not only to impose sizeable and meaningful fines but also suspend a company’s listing in real-time. Whatever the future of the UKLA, these capabilities will clearly need to be retained but arguably the most effective approach would be for the UKLA to continue to have the ability to exercise such functions from within the CPMA, thereby benefiting from the CPMA’s enforcement capability.

Finally, the UKLA is responsible for approving any regulated firm’s application to act as a sponsor under the listing and disclosure rules. The UKLA must also carry out an ongoing oversight of sponsor activities. In doing so, it must consider the competence and experience of the regulated firms in

many areas which will also fall under the scope of the CPMA in the new framework. The UKLA currently has full access to the FSA regarding any regulated firm, including FSA's assessments of the legal and compliance functions in the firm, its conflicts policy and practice, the quality of its control functions, and the quality of its senior management. Ultimately the UKLA must decide whether it is comfortable accepting the required representations from a sponsor with respect to the any issuer's compliance with the listing rules, its available working capital, the quality of its control and management processes, and its board's understanding of its duties under the listing and disclosure regimes. The current integrated structure of the FSA facilitates the UKLA's evaluation of a sponsor firm's competence and support depth as well as its duty to maintain a continuing review of a sponsor firm's competence. To re-position UKLA would, therefore, fracture the oversight of regulated firms acting as sponsors.

3 Risk to the UK's representation in Europe

The majority of regulation relating to the listing of securities originates from the European Union. The transformation of the Committee of European Securities Regulators ("CESR") into a European agency - the European Securities and Markets Authority ("ESMA") - is likely to increase the influence and authority Europe has over domestic regulators. Whilst CESR has been primarily concerned with policy questions, it is expected that ESMA may become increasingly interested in involving itself in supervisory and operational matters.

ESMA, as is the case currently with CESR, will only permit one regulatory body per member state to represent the regulatory interests of that member state at a European level. Were the UKLA to be merged into the FRC and a split between primary and secondary market regulation created between two bodies, one of the resultant bodies would not have its own voice in Europe. Whilst one body could, through close consultation, represent the interests of both or a delegation to an ESMA meeting (or an ESMA working party) could include (non-voting) representatives from another regulator, this would be a cumbersome solution that risks being inefficient and difficult to operate effectively in practice. Moreover, the UK's ability to uphold its position in Europe and protect its unique listing regime is primarily due to the well established heavyweight presence that the UKLA brings to the table at CESR.

So far as we are aware, no other European member state currently splits the regulation of its primary and secondary markets. Were this to happen in the UK, other European member representatives at ESMA may view the relevant UK (voting) representative at ESMA as having a compromised and diluted role. This would clearly result in such representative carrying less weight

that his fellow member state representatives. Moreover, at a higher European level, the proposal to merge the UKLA into the FRC would result in the UK's financial markets being represented by two ministers in Europe (one from the Treasury and one from Department for Business Innovation and Skills). This would, again, be at odds with the approach of other member states and could weaken the UK's voice in Europe further.

The complexities of the UK markets and the wider range of issuers and buyers can often mean that the UK's markets can be misunderstood at a European level. The UK needs a strong voice in Europe to protect its interests and preserve the flexibility and unique nature of its markets which are acknowledged as being the key to the success of London as an international market. With its importance to the economy as a whole, there is also a strong need to preserve the UK's position as one of the most respected and preferred financial markets in the world. In particular, the UK's unique premium listing standard is highly regarded around the world and, together with subsequent regulation of admitted securities, crucial to the attractiveness to companies of listing in the UK; it is important that this (higher) standard is protected. There is a risk that the effectiveness of the UK's representation may be diluted if a combined regulator with responsibility for primary and secondary markets cannot represent formally the UK at ESMA.

4 Conclusion

For the reasons highlighted above, the only way to ensure effective and integrated regulation is for the UKLA function to form part of the CPMA Markets Division and not be merged with the FRC. A decision to move the UKLA to within the control of the FRC could, as discussed above, lead to regulatory "underlap" with a heightened risk of key regulatory matters falling between the gaps whilst also reducing the UK's regulatory robustness both domestically and within Europe.