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Financial Regulation Strategy
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Dear Sirs

Re: CLLS Regulatory Law Committee response: A new approach to financial regulation: the blueprint for reform

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world.

This response to the HM Treasury Consultation on "A new approach to financial regulation: the blueprint for reform" has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introduction

The publication of the White Paper and the draft legislation has provided some more information as to how the Government sees the new regulatory infrastructure, but, taken in the round, the draft legislation provides a scant framework for a fundamental reform which will replace a "tripartite" model of financial regulation with one which has four regulatory bodies. Efficient and effective interaction and co-ordination between these bodies will be critical. This is not only to ensure a 'safe' system of regulation, but also to reassure regulated firms that they will neither be paying for an inefficient duplicative system, in particular one which requires them to provide broadly the same information to more than one regulator, nor at risk of being caught in a cross fire of disagreement or perimeter disputes between regulators. In a crisis situation the interaction between the various bodies will be critical. In particular, we would highlight the following as areas where more detail is required in the primary legislation:

- We do not think that the draft legislation provides adequate underpinning for the interaction between the regulators. The new arrangements are scarcely more clear and binding than the existing tripartite arrangements and involve considerable reliance on an inter-regulator Memorandum of Understanding, and this does not inspire confidence. The objectives of and the fundamental elements that must be covered by any Memorandum of Understanding between regulators should be stated on the face of the legislation, or in secondary legislation. It should not be for regulators to decide what should be covered.

- Similarly, the regulatory scope of the PRA should be based on clear, transparent principles stated in the law; it should not be a matter for its discretion.

- The proposals split the regulation of exchanges from that of the clearing and settlement systems which settle the transactions executed on exchanges and lack clarity on the responsibility for settlement finality designations.

There is also a real risk that the structure will decrease the effectiveness of the U.K. voice in Europe at a time when there has been a considerable shift of power to the European regulatory bodies. There must be much more clarity as to how the regulators will interact to provide a coherent and effective European voice, as it is our understanding that although there are effectively four regulators, the U.K. has only one seat on each European Supervisory Authority.

We are also concerned that the proposals include substantial extensions of enforcement processes and publication of decisions with little protection for the regulated person, for example:

(1) directions in respect of financial promotions: there does not appear to be any prior consultation (or other process engaging the authorised person) before the FSA gives the direction and publishes it;

(2) publication of a warning notice requires only that the target person(s) be consulted and sets some criteria of substance for a decision not to publish - but again neither sets out or requires any additional process or protections.

Indeed, the amendments proposed further dilute the protections that already exist in relation to the giving of warning notices, decision notices and supervisory just as the potential effect of such actions is being magnified by changes such as the two referred to, above. There will continue to be no requirement for the regulator to consult on the statement of procedure it is required to issue under section 395(5). At the very least in light of the changes proposed, the regulators should have to consult, but more than that, Treasury should be required to set minimum standards for such procedures.

We repeat below some of the comments we have made previously, even though they have not yet been taken into account. Where we do so this is because we consider the matter to be one of considerable importance, whether because it raises fundamental issues of natural justice and fair procedure and/or because it has negative implications for the position of the U.K. as a financial centre compared with other major European cities.

Box 2.A: Consultation question
1 Do you have any specific views on the proposals for the FPC?

As set out in our response dated 14 April 2011 to the consultation "A New Approach to Financial Regulation – Building a Stronger System" (CM8012) we express no view on the creation of the FPC as a matter of principle. We note that the draft Bill reflects very closely the proposals in the previous consultation and for that reason some of our comments set out below are very similar to the comments we made in our April response.

The FPC's proposed objective and Treasury control

The FPC's objective links into the Bank of England's revised financial stability objective of protecting and enhancing financial stability in new section 2A of the Bank of England Act 1998. In the absence of a detailed definition of "financial stability", we consider that the provisions of the Bill referred to below make insufficient provision for Treasury control and contain insufficient constraints on the FPC.

Section 9A(2) provides that the Bank's Court of Directors must consult the Treasury about a draft of the Bank's financial stability strategy but is silent about the weight to be accorded to any recommendations made by the Treasury. We consider that this should be made explicit, probably by a "comply or explain" provision of the type included elsewhere.

New section 9(C)(1) provides only for the FPC to exercise its functions "with a view" to contributing to the achievement of the Bank of the Financial Stability Objective. This appears to suggest that the FPC may potentially have other objectives in mind as well so long as its aims include contributing to the Bank's Financial Stability Objective. In any event, it appears to set the FPC a very low target to meet (though we generally welcome the requirement in section 9S(4)(b) for a financial stability report to include an assessment of the extent to which the FPC has succeeded in meeting its objectives).

We note that in proposed new section 9(C)(4) the Government has proposed a balance between financial stability and sustainable economic growth in the terms set out in Box 2B of the previous consultation. The new provision, by its breadth and subjectivity, grants the FPC a wide measure of discretion to exercise its functions in a way that may have a significant effect on the UK's economic development. We remain of the view that the latitude accorded to the FPC is too wide.

While the Treasury may at any time make recommendations under new section 9(D)(1) as to matters the FPC should regard as relevant to its understanding of the Bank's Financial Stability Objective, its responsibility in relation to the achievement of that objective or matters to which the FPC should have regard in exercising its functions, the FPC is not required to comply with the Treasury's recommendations. It is simply under an obligation to notify the Treasury whether or how far it accepts the recommendations and what action (if any) it proposes to take in response to them. We note also that no provision is made for the Treasury to make recommendations about matters which the FPC should not regard as relevant. We consider that the Treasury should expressly have this power. While in practice the FPC may generally follow the Treasury's recommendations, we consider that greater weight should be accorded to the Treasury's recommendations on the face of the Bill and, in

this regard, we note the disparity between the Treasury's powers in relation to the FPC and the FPC's powers in relation to the PRA and FCA.

Finally, we note that in section 9E(1) in the exercise of its functions the FPC must "have regard" to the Bank's financial stability strategy. When taken together with the provisions referred to above, we consider that this creates uncertainty about the full extent of the FPC's functions and the controls over it.

Exercise of functions

From the point of view of the regulated financial services community there is likely to be uncertainty as to the extent to which statements or indications by the FCA or PRA as to future regulatory policy can be relied upon in view of the ability of the FPC to override them. Section 9(A)(2) provides for the FPC to strike a balance between contributing to the achievement by the Bank of the Financial Stability Objective and the advancing by the FCA of any of its operational objectives or the advancing by the PRA of its objectives. However, the provision strikes a balance in such a way that it is likely to enable the FPC to override the FCA and the PRA. The Bill contains a number of provisions for communication or consultation between the various public bodies subject to the provisions of the Bill. There is, however, in this case no mechanism provided 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.

As we have previously commented, the provisions in relation to proportionality (found in new section 9(E)(3)) omit certain elements of the requirement. The formulation of proportionality does not include the requirement that a measure should generally go no further than necessary in order to achieve the legitimate aim being pursued. Furthermore, the provision gives no guide as to how the balance should be struck and who should be taken into account for the purpose of assessing the benefits that are expected to result. Finally, the obligation of the FPC under new section 9(E)(3) is only to "have regard" to the matters set out in that provision. The effect is that the obligation on the FPC to act in a proportionate manner is weakly cast. It needs to be strengthened to give market participants confidence in the integrity of the FPC's exercise of its functions.

Strengthening the requirement in relation to proportionality would give greater comfort that the FPC will exercise its functions in a graduated way. At present, there is no express provision as to how the FPC will choose which of its various powers it will exercise. In this regard we note that in relation to directions by the FPC under new section 9(G), an order by the Treasury under new section 9(K) may, in relation to a prescribed type of measure, require the FPC to maintain a statement of the general policy that it proposes to follow in relation to the exercise of the particular power of direction. Although the giving of directions by the FPC may be relatively rare, given the real consequences that are likely to flow from the making of a direction, we consider that new section 9(K)(4) should provide for the Treasury to be required to impose an obligation on the FPC to maintain a general policy statement in relation to the exercise of the direction-making power.

Accountability

Paragraph 2.28 of the previous consultation indicated that the Government proposed to legislate to exclude individual regulated firms from the FPC's powers, while recognising that

the FPC's macro-prudential interventions may be aimed at a small number of large institutions – perhaps only one or two – that could pose a systemic risk. New section 9(G)(4) sets out that a direction may relate to all regulated persons or to regulated persons of a specified description but may not relate to a specified regulated person. While such provision is welcome, it does not really address the concern that the FPC may effectively stray into taking firm-specific decisions that are properly part of the functions of (most likely) the PRA. No provision is made on the face of the Bill in relation to the rights of systemically important institutions to challenge measures that are directed specifically at them. As noted in our previous response, some of the macro-prudential interventions proposed could (if they were effected by the FSA under the current law) require the use of its OIVoP power under section 45 of FSMA if directed at individual institutions (with the corresponding right to refer the matter to the Tribunal). In practice, given the wide extent of the FPC's discretion and the high threshold for successfully bringing an action for judicial review, there may be little that the relevant institutions may do to secure the accountability of the FPC. While we understand that the Government would be likely to have concerns if a delay in the FPC's directions being given effect could have adverse consequences for financial stability, we do not consider new section 9G(4) provides sufficient safeguards. In addition, we consider that at the very least there should be a general presumption under new section 9(H)(2) that where a regulator is complying with a direction by the FPC, the usual procedural requirements will apply – or, at least, they will apply unless there would be a serious risk to financial stability caused by taking time for consultation.

Similarly, we note that new section 9(J) gives the Treasury a discretion whether to publish a direction under new section 9(G). 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 the relevant provisions of FSMA applicable to them. The presumption under section 9(J) should be in favour of publication, with the possibility of suspending publication only for so long as is necessary in the interests of financial stability.

Box 2.B: Consultation question

2 Do you have any specific views on the proposals for the Bank of England's regulation of RCHs, settlement and payment systems?

Changes to the recognition regime

The changes to the Financial Services and Markets Act seem to us to produce quite wide ranging philosophical changes in relation to the status of recognised bodies. These changes are however given a very low profile and no real explanation in the accompanying text. Whilst we recognise that markets have developed since the recognition regimes were introduced, we believe that they are still important and we are unaware of any failings in those regimes of a kind which would prompt significant change to them. The consultation paper makes no reference to any such failings. Other countries draw regulatory distinctions between those entities that are part of the central infrastructure required for the successful operation of their markets (i.e. exchanges and clearing houses) and distinguish them in a number of ways from other firms. At a European level MiFID clearly recognises that regulated markets, central counterparty, clearing and settlement facilities are not the same as investment firms and makes fundamentally different provision in relation to them. We think that the UK is out of step with other jurisdictions if it seeks to reduce the status of its own recognised bodies.

Under the present law the FSA has a wide range of powers in relation to the recognised bodies, which themselves have some regulatory functions, as recognised by their immunity in connection with the exercise of those functions. We believe that a much fuller discussion of the proposed changes would be appropriate before any decision is made to make them. In particular, we question proposals that would subject such entities to the potential of financial penalties and public censure. Have there really been situations where the absence of these penalties or powers has caused an issue, or is it realistically anticipated that there could be any such possibility? It seems to us to send an entirely different message about the status of these bodies from that which has to date been conferred by "recognition" status.

The paper provides no insight into the reasoning behind any of the changes proposed. The effect of the new structure will also be to fragment the regulation of key parts of market infrastructure which are interdependent, yet there is no detail at all on how the Bank of England, which will oversee payment systems and recognised clearing houses, will interact with the FCA which will be responsible for recognised investment exchanges. We also note that recognised investment exchanges may themselves also wish to provide clearing services, as indeed they have done historically. Only last week the LSE was reported to be in talks to buy LCH Clearnet.

We believe that any further changes to the recognition regime should await European developments (including the proposed MiFID II, EMIR and CSD measures) and that there should be no change to the UK regime in the interim.

Clearing services

We were surprised by a number of references in the paper which seem to equate clearing services with central counterparty services. For example, the statement "CREST (currently an RCH although it is not a central counterparty)", implies that HM Treasury is adopting a much narrower concept of clearing than that which has applied in the UK to date and indeed, which applies internationally. The European Commission produced a paper some time ago which sought to define services provided within the clearing and settlement value chain. We broadly agree with the analysis in that paper. This states that:

> *"After the execution of buy and sell orders, transactions are processed in preparation for the transfer of ownership of the product and the fulfilment of all obligations. Depending on the institution providing this service, several additional services are performed, such as the netting of obligations to ensure fewer processes and cash flows, and in particular the evaluation and management of all relevant sources of risk in order to reduce the probability of failure to meet obligations.*
>
> *In most cases, this function is performed on different levels; firstly by trading parties for their clients, secondly at central counterparty clearing houses (CCP clearing) and thirdly its central securities depositaries (CSD/ICSD clearing)....with regard to the various different clearing levels, it has to be taken into consideration that the clearing performed by a CCP is different from that performed by a CSD. CCP clearing concentrates on trade management, position management, collateral and risk management, and delivery management...CSD clearing concentrates on validating and matching the delivery instructions; the result of which is forwarded to settlement."*

It is clear on this basis that the CREST operator carries on both a clearing and a settlement function, which has always been the view of the authorities, the fact that it is not a central counterparty is of no relevance to the analysis. We therefore consider that it is a recognised clearing house and should be regulated as such by the Bank of England. It is a critical part of UK infrastructure, according to its website over £3.3 trillion of securities are held and transferred through the CREST system. It is surprising therefore, given its importance to the UK infrastructure and the fact that it has been a recognised clearing house from the day it was established, that there should be any doubt as its categorisation or its regulation.

European representation

The FCA has the UK seat on ESMA. We think it is important that the arrangements for interaction between the Bank of England and the FCA in respect of recognised bodies be clarified, if the FCA is to have a role in relation to recognised investment exchanges but not recognised clearing houses. Yet there will be significant developments on the European front which could affect recognised clearing houses. It will be essential that the FCA is properly equipped to represent the UK on these issues.

Other comments

We have the following additional comments:

1. We support immunity from liability in damages for the operator of systems under the Uncertificated Securities Regulations. At present the mismatch between this and the recognised clearing house regime gives rise to legal uncertainty;

2. We support the new powers proposed in respect of payment systems

3. We do not think that Schedule 17A paragraph 8 can be correct, financial instruments are not traded on a recognised clearing house, trading has already occurred, and therefore the notion of suspending or removing a financial instrument from trading has no application in this context. We do not in any event consider that a recognised clearing house is an institution within the meaning of new section 313A.

4. It is not clear to us what the intentions are in relation to settlement finality designation, as currently the FSA is responsible for designating systems operated as a recognised investment exchange or recognised clearing house. There is a need to tie up settlement finality designation with the division of responsibilities between the Bank of England and the FCA.

Box 2.C: Consultation question

3 Do you have any comments on:

- the proposed crisis management arrangements; and
- the proposals for minor and technical changes to the Special Resolution Regime?

Crisis management

As indicated in our earlier response, there is a fundamental need for coordination across the authorities in a crisis management situation. Creating clarity of roles and a requirement to enter a memorandum of understanding are welcome first steps, but are insufficient on their own to create the conditions for effective coordination.

Statutory provisions and a change in structure are not sufficient conditions to coordinated crisis management however. Effective coordination of crisis management requires the authorities to ensure cooperation and mutual understanding – and more critically it involves careful preparation and planning.

The interaction between the Bank and the PRA in advance of a crisis situation will be key to how successfully it is resolved. The creation and role of the Bank of England Special Resolution Unit in the FSA Recovery and Resolution Plan pilot has been a useful first step to better coordination between the authorities, and to more considered preparation for crisis situations. It is clear that more needs to be done to prepare the authorities for future crisis situations. This is likely to include assessment and transmission of relevant information between PRA and Bank staff as a firm nears crisis; war gaming failures of specific firm failures; and engagement of Bank staff through the implementation of firms' recovery plans (to enable consequential amendments to resolution planning). Consideration might also be given to a programme of secondment between the PRA and SRU.

We necessarily defer comment on the quality of the memorandum of understanding until it is published.

Special Resolution Regime

We welcome the proposed changes to the Special Resolution Regime proposed in clauses 59, 61 and 62 and have no comments on these. As a general point we welcome the willingness of the Government to limit the override powers relating to trusts in section 34(7) of the Banking Act. However, we believe that the changes proposed to section 34(7) (the "trust override") leave too much latitude to the Bank.

There has been justifiable criticism of the trust override power: the power gives rise to considerable legal uncertainty on the part of market participants as to how (rights in) trust property would be affected on a resolution, and is not justified by the needs of the authorities. The purpose of the override is to enable transfer with minimal damage to contractual and property rights – either of trustees or beneficiaries – and it is right that the power should be strictly limited to what is necessary to enable that to occur. To this end the new proposed subsection (8) is welcome: but it should apply not just to subsection 34(7)(a) but also subsection 34(7)(b). Further, we would question whether it would ever be justifiable for the Bank to remove (terminate) the terms of a trust in the exercise of its powers: we would therefore suggest the deletion of the words "or remove".

The Prudential Regulation Authority

Box 2.D: Consultation question
4 Do you have any comments on the objectives and scope of the PRA?

Box 2.E: Consultation question

5 Do you have any comments on the detailed arrangements for the PRA?

Objectives and scope

General objective

We are pleased to note that section 2B(2) and (3) FSMA would in effect contain two distinct operational objectives concerning: (1) the promotion of safety and soundness of PRA authorised persons; and (2) seeking to minimise any adverse effect that the failure of a PRA authorised person could have. As mentioned in our response to the previous consultation (A new approach to financial regulation - building a stronger system) it is incorrect to say that the promotion of the safety and soundness of PRA authorised persons "includes" seeking to minimise any adverse effect that the failure of that person could have on the UK financial system.

However, we are disappointed that the objectives are expressed in such bland terms, indeed in words that connote duties, actions and performance rather than aims. Given the express terms of section 2F, which limits sections 2B to 2D to emphasise that the PRA is not required to ensure that no firm fails, we consider that its objectives should be expressed as such, by deleting the references to "promoting" and "seeking" in sections 2B(2) and 2B(3)(b), to leave:

- "the safety and soundness of PRA authorised persons" and
- "minimising the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system".

The latter is critical as the test of success is surely whether adverse effects were minimised rather than whether the PRA merely sought to minimise them.

We question also the term "safety" in the general objective (section 2B(2)). It is unclear from what kind of risk (financial collapse, crime, etc) PRA firms are to be safe and for whose benefit (consumers, shareholders, society at large). A term more focussed on the risks (such as "financial strength") or clarification of the relevant stakeholders would help.

One approach to consider would be to base the objectives on the text of section 2B(3) (a) and (b) and add an objective similar to the specific insurance objective:

- Securing an appropriate degree of protection for those who are or may become depositors or other consumers of financial services.

See further on this below.

Another substantial point arises from section 2B(4). We would submit that the reference to adverse effect should include some notion of materiality, either by qualifying the reference itself ("material adverse effect") or by clarifying inter alia that a mere increase of risk is not necessarily an adverse effect.

Insurance and additional objectives

We welcome the new section 2C FSMA concerning the PRA's insurance objective. However, we are concerned about several aspects arising from the relative priorities and scope of this and other objectives.

'Equal priority' between this objective and the general objective could lead to compromises that may not truly satisfy either objective. We note that the creation of additional objectives is envisaged under section 2D FSMA and it is therefore important that both the regulator and the market have a clear understanding as to how conflicts or inconsistencies between the objectives are resolved. Whilst section 2H envisages the PRA publishing guidance regarding the discharge of its own objectives, this obviously creates a conflict of interest in the PRA; and it would be better if further clarity were provided for in the primary legislation itself (or by Treasury in a statutory instrument). In particular:

- it should not be for the regulator to determine its own scope (even in consultation with the other – which in any event could still lead to conflict or inconsistency); and
- in any event it is not appropriate for PRA guidance to be capable of extending or curtailing the scope of such important provisions as objectives.

Given Treasury's power under section 3G to establish the boundary between FCA and PRA, and the affirmative resolution required, the exercise of article 2H powers under 2H(1)(b) should require consultation with Treasury. And, consistent with section 3G, the provisions should refer to "...its, or primarily its responsibility..."

Since a key focus of the reforms is stability, the insurance objective and any other "specified objectives" should be subordinate to the general objective except in two ways:

- in respect only of the *financial supervision* of insurance and reinsurance undertakings, Solvency II will require the main objective to be protection of policy holders and beneficiaries (article 27), but nevertheless that the financial supervisor duly considers financial stability (article 28);
- to the extent otherwise provided in an order passed by affirmative resolution.

There has been insufficient attention paid to the implications of the insurance objective for the general objective. For example, why should not deposit holders be expressly mentioned as a focus of protection? This reinforces the point made above, though we recognise that any broad objective should be conditioned to an extent by reference to prudential regulatory issues rather than issues within the FCA's purview.

As to the wording of the insurance objective in section 2C(2), we have two concerns:

- "contributing to.." is weak and bland in the same way as the "promoting" and "seeking" in the general objective: if "contributing" is intended to refer to the fact that the FCA may have some responsibility in this area, that should be made clear, otherwise the objective should be simply "securing..." and section 2F would ensure this would not be construed as implying no failure of an insurer or reinsurer;
- further clarification is required on the meaning of the term "appropriate degree of protection". One can read appropriate as 'proportionate'. What is clear is that this is

not the idea of policyholders' reasonable expectations which was a terminology used before FSMA. Here PRA guidance under section 2H, on how it will construe the objective, is critical, as is clarification that it excludes conduct issues which are properly the FCA's concern.

Regulatory principles

Innovation: We would again urge the Government to reconsider its position not to include as a principle the desirability of facilitating innovation. Without such a principle it will be difficult for supervisors to give any weight to the benefits for users of financial services of new products and services, as against any risk to firms or consumers they may pose. We repeat that the principle should be included and consideration given to its reformulation.

Mutuality: We welcome the 'diversity have regard to' provision contained in new section 138L FSMA concerning mutual societies. However, whether this will prove to be useful to mutual societies depends upon the level of detail that will be set out in the regulator's statement. We note that the legislation uses the words "significantly different" but it is not clear what exactly this means. If the Government is serious about promoting mutuality, we suggest that the desirability of promoting the development of mutual societies be added as a principle in section 3B.

Competition: We welcome the Government's action to update the existing competition scrutiny regime which will apply to both the PRA and the FCA. Whilst the Bill provides for a competition link to the FCA's strategic and operational objectives (new section 1B(4) FSMA) it is strange that there is no competition link in the case of the PRA's objectives or principles. Competition is a key issue in light of the plethora of prudential regulatory changes since the financial crisis (including those still to come).

Scope in relation to investment firms

With regard to investment firms, we would repeat the point made in our previous response that there is a clear conflict of interest in permitting the PRA to determine the scope of its own jurisdiction in relation to particular investment firms. Certainty of approach is the most crucial issue for firms that have permission to deal as principal. The test needs to be both clear and objective. This is so both for firms currently based in the U.K. and for overseas firms deciding where to base European or global headquarters. They need a clear answer as to what their position would be if they were to choose London. If their first encounter with trying to understand the U.K. regulatory landscape produces an impression of vagueness and subjectivity as to how they will be treated, they will opt for jurisdictions with clear transparent structures. We would submit in particular that:

- Since the express intention (as stated in paragraph 2.57 of the White Paper) is to capture systemically important investment firms, the Treasury should lay down criteria to assess this (as have been developed in other fora (such as the BIS/FSB) and jurisdictions (such as the US where, under the Dodd-Frank Act, the new Financial Stability Oversight Council has been consulting on factors to consider in respect of different types of financial institution). We note that the FSA has recently published a consultation paper concerning recovery and resolution plans and it is proposed that some of the larger investment firms be required to prepare such plans. Subject to the overriding need for proportionality, we suggest that the criteria for both (i.e. PRA regulation of investment firms and the need to prepare such plans) be the same. Unless clear and objective criteria are to be specified in the Act or a statutory