The Financial Conduct Authority
An overview

1 April 2013
Contents

1_Background and scope 03
2_FCA: review of scope/remit and objectives 04
3_FCA’s approach to regulation/supervision 14
4_FCA statutory powers, accountability and possible challenges 21
5_Interaction between the FCA and other authorities 33
6_FCA’s interaction with the European System of Financial Supervisors (the ESFS) 37
7_FCA business plan and risk outlook 2013/14 42
1_Background and scope

The current model of financial regulation – a tripartite system under which the responsibility for financial regulation is shared by HM Treasury (HMT), the Bank of England and the Financial Services Authority (the FSA) – has been under fire since the start of the financial crisis in 2007 for failing to address deficiencies within the financial system. In response, a new system of financial regulation sees the creation of three new bodies:

- the Financial Policy Committee (the FPC) in the Bank of England which will be responsible for macro-prudential regulation – regulation of the ability and resilience of the financial system as a whole;

- the Prudential Regulation Authority (the PRA), an independent subsidiary of the Bank of England, which will be responsible for micro-prudential regulation of financial institutions that manage significant risks on their balance sheets; and

- the Financial Conduct Authority (the FCA) which will have responsibility for the conduct of business and markets regulation.

This paper reviews the FCA which was formally created on 1 April 2013. It concentrates on the FCA's:

(a) remit/scope and objectives;

(b) approach to regulation/supervision;

(c) statutory powers, accountability and possible challenges;

(d) interaction with the other two authorities and potential problem areas of overlapping powers/authority;

(e) interaction with the European System of Financial Supervisors; and

(f) transition from the FSA.

Schedule 1 and Schedule 2 of this paper set out a diagram of the regulatory structure of the new regime and a table outlining the functional overview of the FCA. Schedule 3 contains a table of the international bodies in which the FCA will have either a seat or an interest.

The Financial Conduct Authority: Approach to Regulation paper (the FCA Position Paper) and the HMT paper entitled A new approach to financial regulation: the blueprint for reform (HMT’s Paper), both published in June 2011, and the FSA paper entitled Journey to the FCA (Journey to the FCA) published in October 2012 provide useful commentary and narratives on the Financial Services Act 2012 (the Act), which amends the Financial Services and Markets Act 2000 (FSMA) to effect a radical change to the architecture of financial services regulation in the UK.
2_FCA: Review of scope/remit and objectives

2.1_Scope/remit

Who the FCA regulates

The FCA will regulate firms in the UK providing financial products and services to both UK and international customers. In total, Journey to the FCA estimates that this will encompass approximately 26,000 firms. Of this number the FCA will be the prudential and conduct of business regulator of approximately 23,000 firms. For the remaining 3,000 firms the FCA will only be responsible for the regulation of conduct while the PRA will take responsibilities for the prudential regulation of these firms. The approach taken by the Act places the FCA as the prudential regulator of all firms other than those regulated by the PRA. A Memorandum of Understanding (MoU) will support the relationship between the two bodies and allow the PRA to provide support to the FCA on prudential matters. This relationship is discussed in further detail at paragraph 5.2 below.

Diagram 1 depicts the system of dual regulation envisaged by the Act and shows the interaction between the FCA and the PRA.
The dual regulation of prudential matters will allow the PRA to concentrate its prudential regulation on those institutions in which retail investors are at particular risk, including deposit-taking institutions, insurers (including managing agents at Lloyd’s and arranging by the Society of Lloyd’s of contracts of insurance written at Lloyd’s) and significant investment firms. The FSMA 2000 (PRA-Regulated Activities) Order sets out the conditions for PRA regulation (at article 3). In addition to deposit-takers and insurers, persons that deal in investments as principal will be conducting PRA-regulated activities if:

(a) the person investing as principal is an investment firm that meets the requirement under Article 9 of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions to have an initial capital of EUR730,000 (or would meet this requirement if the firm was subject to the Directive 2006/49/EC); and

(b) the PRA considers that PRA supervision is desirable, having regard to its objectives.

The factors to which the PRA must have regard in considering (b) above include the assets of the firm, and if the firm is a member of a group, the assets of any other firms within the group which have permission to deal in investments as principal and are required to have EUR730,000 capital; whether any other firms in the group have been designated; and whether the firm’s activities could have a material impact on the PRA’s ability to promote the safety and soundness of other PRA-authorised entities in the group. As the explanatory note to the draft Order states, designations under article 3 relate to particular firms, rather than to a class of firm.

The Bank of England’s paper Designation of investment firms for prudential supervision by the PRA: consultation on a draft policy statement states that the PRA will have regard to the following factors: (i) whether the firm’s annual balance sheet exceeds an average of GBP15 billion in total gross assets over four quarters; and/or (ii) whether the sum of annual balance sheets of all eligible investment firms in a group exceed an average of GBP15 billion in total gross assets over four quarters; and/or (iii) where the firm is part of a PRA group, whether the firm’s revenues, balance sheet and risk-taking is significant relative to the group’s revenues, balance sheet and risk-taking. As the paper suggests, the materiality of an individual entity requires specific knowledge of the group in question, so consideration of the final factor will be “a matter of judgement for the PRA”.

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### TABLE 1: FCA – REGULATED FIRMS

The table below lists in detail the types of firm that the FCA Position Paper anticipates will fall within the FCA’s regulatory ambit – whether for both conduct and prudential regulation or just for conduct of business.

<table>
<thead>
<tr>
<th>Conduct of business and prudential</th>
<th>Conduct of business only</th>
<th>Under other legislation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal investment firms</td>
<td>Banks</td>
<td>Electronic money institutions¹</td>
</tr>
<tr>
<td>Insurance intermediaries</td>
<td>Building societies</td>
<td>Payment institutions²</td>
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<tr>
<td>Mortgage intermediaries</td>
<td>Investment banks</td>
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<tr>
<td>Investment managers</td>
<td>Credit unions</td>
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<tr>
<td>Non-deposit taking lenders</td>
<td>Friendly societies</td>
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</tr>
<tr>
<td>Corporate finance</td>
<td>Life insurers</td>
<td></td>
</tr>
<tr>
<td>Wholesale firms</td>
<td>General insurers</td>
<td></td>
</tr>
<tr>
<td>Custodians</td>
<td>Wholesale insurers, commercial insurers &amp; reinsurers</td>
<td></td>
</tr>
<tr>
<td>Professional firms</td>
<td>Lloyd’s &amp; Lloyd’s Agents</td>
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<tr>
<td>Markets (exchanges &amp; infrastructure providers)</td>
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<tr>
<td>Collective investment schemes</td>
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<tr>
<td>Other (including travel insurance only and media firms)</td>
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<td></td>
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<tr>
<td>Other brokers</td>
<td></td>
<td></td>
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<tr>
<td>Managing agents</td>
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<tr>
<td>Investment firms</td>
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</tbody>
</table>

¹ Those firms authorised or registered under the Electronic Money Regulations 2011.
² Those firms which are registered or authorised under the Payment Services Regulations 2009 and incoming EEA-authorised payment institutions.
Categorisation of Firms by the FCA

The FCA will categorise all firms for the purposes of conduct supervision and will categorise FCA-regulated firms for prudential supervision.

The conduct supervision categories are C1, C2, C3, C4. C1 and C2 firms will be judged to pose the greatest risks to consumers or market integrity, while C3 and C4 firms will be considered to have a lower impact on the FCA’s objectives. According to Journey to the FCA, categorisation will use a combination of “current impact measures, retail customer numbers and some measures of market impact”. The precise details of the FCA’s methodology is still not clear, but in general, the list of firms in each category will be as follows:

- C1 will include banks and insurance groups with a very large number of retail customers and universal or investment banks with very large client assets and trading operations;
- C2 will include firms across all sectors with a substantial number of retail customers or significant wholesale firms;
- C3 will include firms across all sectors with retail customers or a significant wholesale presence; and
- C4 will include smaller firms, including almost all intermediaries.

The category of firm will determine the style of supervision the FCA carries out, with specific FCA supervisors allocated to firms judged to pose a greater risk (i.e. C1 and C2 firms as well as a limited number of C3 and C4 firms that are judged to be outliers compared to their peers) while there will be a number of sector specialists that are deployed flexibly to oversee the vast majority of C3 and C4 firms.

The FCA will adopt a similar method to categorising firms for the purposes of prudential supervision. Again, the type of supervision will depend on the nature of the firm, with firms classified as prudentially critical firms (CP1), prudentially significant firms (CP2) and prudentially insignificant firms (CP3).

Areas the FCA will regulate

It is clear from HMT’s Paper and the FCA Position Paper that the FCA as the financial market conduct regulator will have broad ranging responsibility in both retail and wholesale markets. The FCA will continue to have responsibility for areas previously held by the FSA and will potentially take on responsibilities in new areas such as consumer credit.

The FCA’s responsibility as market conduct regulator can be split into three areas:

- supervising trading of financial instruments infrastructure (other than systemically important infrastructure – central counterparty settlement systems and clearing houses – for which the Bank of England will be responsible);
- supervising markets for issuing of securities, including the UK Listing Authority. The FCA will perform the functions that the FSA previously performed and will therefore be responsible for reviewing and approving prospectuses and circulars, determining eligibility for listing and maintaining the Official List; and

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oversight of on-exchange and over-the-counter markets and monitoring to prevent market abuse. The FCA will also police the ongoing compliance of issuers and major shareholders with the ad hoc and periodic disclosures required under the Disclosure and Transparency and Listing Rules. The FCA will authorise and monitor the performance of sponsors and, if reforms are enacted, other primary information providers.

The FCA will also be responsible for countering financial crime. The FCA is to have regulatory oversight of client assets, a role which entails the identification and mitigation of risks. The FCA Position Paper states that the FCA is to continue the Client Asset Units’ drive for higher standards in safeguarding client money and will aim to build on the FSA’s intensive and intrusive supervisory approach. The emphasis in the area of financial crime is on credible deterrence.

The Government in its consultation paper A new approach to financial regulation: building a stronger system indicates that the FCA will have responsibility for the operation of Financial Crime Information Network (FIN-NET). The FCA will maintain links with other actors in the area of financial crime, including the Police, the Serious Fraud Office (the SFO), the Serious Organised Crime Agency (SOCA), the National Fraud Authority and in future the Economic Crime Agency (the ECA) and the National Crime Agency (the NCA).

The FCA will have joint responsibility with the PRA for the Financial Services Compensation Scheme (the FSCS) and the Government intends that the FCA is to continue the FSA’s role in relation to the independent dispute resolution service that the Financial Ombudsman Service (the FOS) supplies. Statutory memoranda of understanding are expected to be published before the introduction of the FCA, outlining details on how the FCA will co-ordinate with the FSCS and the FOS.

Two areas of potential expansion of responsibility are competition and consumer credit.

Consumer credit

The FSA was responsible for the regulation of banking, including the provision of current account products, loans and mortgages to retail consumers. However, the FSA was not responsible for the regulation of all aspects of consumer credit as products provided under the Consumer Credit Act 1974 (CCA 1974) fall under the responsibility of the Office of Fair Trading (OFT). Section 107 of the Act provides the Treasury with the power to transfer, by way of Order, functions of the OFT under any provision of the CCA 1974 that remains in force to the FCA.

The Government announced in January 2012 that it would transfer responsibility for regulating consumer credit from the OFT to the FCA by 1 April 2014, providing it could be satisfied that a proportionate regime could be designed. The Government has now published a consultation paper setting out its proposals, including an interim permission regime during which firms will have to apply for full authorisation or a variation of authorisation. The interim regime will end by 1 April 2016. The FCA’s regulatory framework for consumer credit activities will be a combination of existing and new FCA rules (which will be consulted upon in Autumn 2013), FSMA and secondary legislation and certain returned provisions of the CCA 1974 and secondary legislation. This approach is in line with the intention to move to a more responsive, rules-based regime than the current statutory framework.

The FCA will have stronger powers and greater resources than the OFT has had in order to tackle detrimental practices in the consumer credit market. Unlike the OFT, the FCA will be able to make binding rules on firms to ban specific products or product features that cause harm, to issue unlimited fines, and to require firms to pay redress. It will also be able to apply greater scrutiny to applications for credit licences and make it more difficult for rogue firms to enter the market.

The FCA sees the task of transferring consumer credit as a longer term project calling it “an evolving regime”.
It intends to keep the regime design under review and is required by April 2019, to deliver to the Government a report on whether the repeal of the remaining provisions of the CCA 1974 would adversely affect consumer protection.

**Competition**

Currently the FSA does not have explicit competition powers. These lie with the OFT and, with respect to mergers and markets investigations, the Competition Commission. The FCA does have, however, a new mechanism to refer a matter to the OFT for consideration.

The FCA's new competition objective and duty means that the FCA will be required to identify and address competition problems and adopt a more pro-competitive approach to regulation. The FCA will seek to minimise or limit distortions in competition with a particular focus on meeting consumer needs and ensuring that there are no undue barriers to entry or expansion. Journey to the FCA has stated that sound and thorough market studies and “pro-competitive”, “wide-reaching” remedies will provide the tools for improving value and quality for consumers.

To achieve this, it is proposed that the FCA will weigh up the impact on competition of any new measures it proposes for dealing with a particular problem using an “enhanced approach” to its market failure analysis. The enhanced approach will entail intelligence and information gathering from a variety of sources including firms, consumer groups and competition regulators to identify risks.

When carrying out analyses of business models and strategy, the FCA will take account of a firm’s competitive position in various markets then assess potential conduct risks arising from their strategies. The FCA will also carry out studies of markets where its intelligence gathering indicates that competition is not functioning well.

The details of the FCA's proposed approach to competition is currently under consultation.

In his evidence to the Treasury Select Committee in November 2012, John Griffith-Jones, FCA Chairman Designate stressed that one of the challenges will be ensuring that the FCA has the necessary skill set to meet its competition objective and will need to work closely with the OFT which has significant experience in this area.
2.2_Objectives

When discharging its general functions of rule-making, preparing and issuing codes under FSMA, giving general guidance or determining the general policy and principles the FCA must, so far as is reasonably possible, act in a way which is compatible with its strategic objective of ensuring that relevant markets function well, and advances one or more of its operational objectives of:

– securing an appropriate degree of protection for consumers (the consumer protection objective);
– promoting effective competition in the interests of consumers in financial markets (the competition objective); and
– protecting and enhancing the integrity of the UK financial system (the integrity objective).

So far as it is compatible with its consumer protection and integrity objectives, the FCA must discharge its general functions in a way which promotes competition.

When discharging its general functions the FCA is to have regard to its eight regulatory principles (which also apply to the PRA):

– the need to use its resources in the most efficient and economic way;
– the principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected as a result;
– the desirability of sustainable growth in the economy of the UK in the medium or long term;
– the general principle that consumers should take responsibility for their decisions;
– the responsibilities of senior management to comply with the regulatory framework;
– the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature and objectives of regulated businesses;
– openness and disclosure: the FCA is to make market information available, with appropriate safeguards, to reinforce market discipline (e.g. publishing information about regulated persons or requiring them to publish information); and
– transparency: the FCA is to exercise its functions as transparently as possible. This principle aims to ensure that appropriate information is provided on regulatory decisions and that the FCA is more open and accessible to the regulated community and the general public.

The FCA also has a free standing duty to have regard to the importance of minimising the extent to which regulated businesses may be used for a purpose connected with financial crime.
This web of objectives sees the abolition of several of the FSA’s previous objectives, including “the desirability of facilitating innovation in connection with regulated activities”, “the desirability of enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system)” and consideration of “the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom”.

The removal of the innovation and public awareness objectives is highly informative of how the FCA will operate – the FCA will regulate without concern for creation of dynamic markets and will not concern itself with educating consumers. The role of educating consumers, however, has not been completely abandoned – the Money Advice Service will continue this role – allowing the FCA to focus on ‘pure regulation’. In a similar way the removal of the international competitiveness objective is informative: regulated firms have indicated that the UK’s position as a global financial centre will be at a disadvantage as a result of regulatory intervention.

The removal of this objective may give the FCA more scope to “gold-plate” EU rules which could lead to UK firms being less able to compete in Europe and European firms with investments in UK financial services firms withdrawing from the UK market as a result.
Consumer protection

In a speech on 25 January 2012 Martin Wheatley stated that it is “important to understand what's going to be at the heart of the FCA, and that is getting a fair deal for consumers”. The introduction of consumer protection as one of the FCA's operational objectives will be the vehicle for this new approach. The FCA's consumer mandate is further expanded as a result of the broad spectrum of persons who fall under the definition of 'consumer' in new section 1G of FSMA. The FCA Position Paper notes that the definition of consumer will cover:

- retail consumers buying financial products for their own use or benefit either directly or through a regulated firm;
- retail investors in financial instruments; and
- a wide selection of wholesale consumers, including:
  - any regulated firm buying a product or service on behalf of another person (when they anticipate selling the product on to a retail consumer);
  - any regulated firm acting as agent or as a fiduciary;
  - investors in financial instruments;
  - regulated firms trading across markets to manage their own risk or inventory of stock; and
  - non-regulated corporates buying financial products for their own use and issuers looking to raise capital who then go on to buy services or advice from investment banks in the course of regulated activities.

The FCA approach to consumers is also wide in the sense that it is not just direct conduct with consumers that the FCA must consider in relation to the duty to protect retail consumers: Journey to the FCA states that the FCA will also look at the possible impact on retail consumers of poor conduct in wholesale markets, even where the linkage is indirect, such as structured products that originate in investment banks but are packaged and sold in the retail market.

Interplay between the FCA objectives

As outlined above, competition is to be promoted to the extent that it is compatible with the FCAs consumer protection objective and integrity objective. The FCA Position Paper states “competition is a key driver of choice and efficiency in markets”. The interrelation between competition and the other objectives boosts the duty of the FCA giving it a significant role in promoting competition within the financial services sector. This interplay of objectives begs the question of balance: how are the tensions between objectives to be balanced against one another?

Other areas in which a balance must be achieved or a trade-off must be made include:

- responsibility and suitability: the extent to which individual consumers should be held responsible for and given the freedom to make their own decisions.
- intervention and innovation: early intervention is positioned as a central concept of the new framework. In some circumstances intervention may create more harm than good.
- transparency and efficiency: transparency, a key concept of market integrity, can be administratively burdensome and can have a destabilising effect on markets; disclosing concerns can exacerbate the situation.
- cost and effectiveness: a more proactive and interventionist regulator means greater cost. The FCA, in order to be effective and as active as the Government’s proposals hopes, will require substantial funding.
- accountability and judgement: the FCA will need to make bold forward-looking judgements. This will be difficult and with hindsight, decisions may not always lead to the desired result.
Interplay between the FPC, PRA and FCA objectives

The objectives proposed by the Act are a shift from the current statutory framework. The FPC, PRA and FCA are each to have their own objectives, which introduces an extra level of complexity to the interrelation of objectives. For example, the FPC has an objective to support the economic policy of Government, including objectives for growth and employment, which may conflict with the FCA’s operational objective of promoting competition. Because the FCA is subject to the FPC’s recommendations, conflict between the priorities of the two organisations may only be resolved to the detriment of the FCA’s operational objectives.

Similarly, the PRA has financial stability as its general objective, and there may be tensions with the FCA particularly when prudential and systemic stability concerns are seen to override consumer protection issues in the case of institutional failures. Although the PRA and FCA are designed to communicate with one another, the extent to which the PRA uses its power of veto over the FCA when its financial stability objective is impacted upon may affect the relationship and degree of co-operation that exists between the regulators.

A diagram setting out the regulatory structure can be found in Schedule 1.
3_FCA’s approach to regulation/supervision

3.1 General approach

A major theme of the Government’s reform package is the move away from a culture of so-called “compliance based” supervision which the Government says is characterised by “box ticking” to supervision which “empowers” regulators to “look beyond compliance, supervise pro-actively and to challenge”, an approach which is described as “judgement-led”. Journey to the FCA states that the new approach will be to carry out “in-depth, structured supervision work with those firms with the potential to cause the greatest risk to [the FCA’s] objectives”.

Much emphasis has already been placed on the need for the regulators to have experienced senior staff to make such judgements, and the challenges created by this approach are acknowledged in the FCA Position Paper. The impact judgement-led supervision will have on firms’ day-to-day engagement with the regulators is less clear but in some cases firms may need to re-evaluate whether their practices, while being in strict compliance with the rules, are not within the spirit of the rules. Practices which seem to be accepted may come under renewed scrutiny. In theory, firms should expect more transparency from the regulators as to the intended purpose of the rules, and this is reflected in the statement in the FCA Position Paper that the FCA will be a regulator that “says what it means”.

A second major theme of the reform package is the FCA’s desire to be seen as being “tougher and bolder” than the FSA, building on the FSA’s credible deterrence strategy. Combined with the judgement-led approach to supervision, this is likely to mean that firms’ engagement with the regulator becomes more adversarial in nature than it has been under the FSA. In this regard Journey to the FCA states that the FCA will “focus attention on the bigger issues, either in individual firms or within and across sectors and have a more open, engaged and challenging approach with firms at the senior management and board level”.

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3.2_The conduct mandate

The FCA’s supervisory approach will be moulded significantly by the perceived supervisory failures of its predecessor, the FSA. In particular, the mis-selling of payment protection insurance (PPI) is given as a recent example of industry behaviour which resulted in large-scale detriment to consumers. While the FCA Position Paper describes the outcome of the PPI incident as being “ultimately successful”, there is a recognition that such events undermine consumer confidence in the financial system. The FCA will therefore focus on prevention rather than redress. In this regard, the FCA Position Paper states that:

“[T]he FCA will need to: spot issues earlier; be willing to intervene early to improve standards either in specific firms or wider; take robust action designed to address weaknesses in competition revealed by economic analysis…”

This emphasis on early intervention implies a step change in conduct regulation for authorised firms. In particular, the FSA approach relied heavily on product disclosure to secure acceptable outcomes for consumers. While the existing rules concerning product disclosure are expected to remain in place, it is clear from the FCA Position Paper and the Act that disclosure is considered necessary, but not sufficient to secure acceptable outcomes for consumers. The FCA’s interventionist strategy will therefore include the following elements:

(a) There will be an increased emphasis on intelligence gathering to identify emerging conduct risks. The FCA Position Paper, in particular, focuses on thematic review and trend-spotting, rather than close supervision of individual firms. Intelligence gathering will take the form of direct engagement with consumers and the industry, for example through the proposed appointment of panels representing the interests of stakeholders and through activities conducted by the new Policy Risk and Research team, which will act as the radar of the new organisation.

The Policy Risk and Research team’s research into what is happening in markets and to consumers will drive the actions that are taken across the FCA. In addition to conducting economic and market analysis, the Policy Risk and Research team will analyse media, consumer complaints, enquiries and intelligence from consumer organisations and professional firms to identify risks to consumers, firms and markets. It will seek to create a common view to inform the FCA’s authorisation, supervision and enforcement divisions and will use the knowledge of these risks to make evidence-based policy that changes behaviour. Journey to the FCA states: “by bringing together our information-gathering, analysis, research and policy making into one place, we aim to make sure that we are in a position to make timely and effective interventions when we identify risks”.

In line with the FCA’s focus on thematic work, the FCA will adopt a “sectoral risk assessment” to drive its issues and product work, working with a range of data and intelligence from firms, consumers and trade bodies. We expect that it will be through these thematic activities, rather than through the close supervision of individual firms, that the FCA will identify products which are candidates for the exercise of the product intervention power, discussed further below.

(b) There will be a new focus on competition as a means of delivering better consumer outcomes by promoting efficiency and choice in the financial markets. As explained above, this is reflected in the FCA’s duty under the Act to discharge its functions in a way which promotes competition. How this duty will be reflected in practice is not clear, however: the examples given in HMT’s Paper and the FCA Position Paper suggest that rules mandating enhanced switching and exit rights (promoting the consumer’s
ability to choose) are under consideration. The FCA will have to work closely with the PRA to ensure that the desirability of choice is balanced against the inherent cost for some financial services firms (e.g. long-term insurance providers) of providing flexibility.

Also of interest is the FCA’s proposed emphasis on price as an indicator of competitiveness. While the FCA Position Paper explains that the FCA will not be an economic regulator, it also seems clear that the FCA may be prepared to intervene on price in circumstances where the market in question is failing to deliver fair consumer outcomes, for example, as a result of a lack of competitiveness.

(c) Recognition of the importance of arming consumers with information about products being offered by firms, and about the firms themselves. This is consistent with the general regulatory principle expressed in the Act that consumers should take responsibility for their decisions. How this information will enhance the information which is already required to be provided under current FSA rules is not clear.

The FCA’s regulatory principles require the FCA to be more transparent on regulatory decisions and disciplinary actions (see section 3B of FSMA), including information concerning disciplinary action becoming known at an earlier stage.

On a practical level, the approach to conduct supervision will involve replacing the Arrow risk assessment framework. Under the new regime, the supervision model will be based on three pillars:

- a Firm Systemic Framework (FSF), which seeks to prevent harm to consumers by assessing the conduct of firms;
- event-driven work, where the FCA aims to deal faster and more decisively with problems that are emerging or have recently occurred; and
- work on issues and products that may put consumers at risk.

Fewer firms will be subject to a relationship managed supervision strategy, while a greater proportion of firms will be subject to the “small firms” model. This implies a shift in resources from supervision of individual firms and may, for some firms, result in less engagement from the FCA than was previously experienced in relation to the FSA. While the proportion of firms that are “relationship managed” will reduce, the FCA Position Paper is clear that firms of systemic importance will continue to be supervised on that basis. This is consistent with (and an expression of) the FSA’s statement that the FCA will employ a “risk-based” approach to supervision and the deployment of resources. Further, being more flexible on how supervisors are allocated to firms will mean that event driven work and issues and product work can be carried out more promptly and with greater effect.

FSF involves a “business model and strategy analysis” which aims to answer the question, “are the interests of customers and market integrity at the heart of how the firm is run?” The business model and strategy analysis will have four modules:

- governance and culture, which assesses how effectively the firm identifies, manages and reduces conduct risk;
- product design, which looks at whether the firm’s products or services meet customer needs and whether customers are targeted accordingly;
- sales processes, which are an assessment of the firm’s systems and controls; and
- post-sales handling, which looks into how effectively the firm ensures that its customers are treated fairly after the point of sale, service or transaction, including complaints handling.
In contrast to the Arrow system, the FSF will assess the drivers of conduct risk, rather than involving issues-based discovery work and the results of the analysis will focus on a few key areas, rather than on a number of areas under the current firm-specific risk mitigation programmes.

Also, under the new approach, the FCA will make greater use of section 166 powers to appoint skilled persons under FSMA and new section 166A powers of the FCA and PRA to appoint skilled persons to collect and update information. This will ensure that any follow-up work required by the FCA has been completed by the firm. However, there are concerns in the industry that this will only add to the regulatory cost and burden on firms, which are responsible for the costs of producing skilled persons reports. Note that the new skilled persons’ powers in both sections 166 and 166A enable the FCA or PRA to appoint a skilled person. In practice this will mean that the FCA or PRA will have the power to contract directly with the skilled person and require that the costs of that skilled person be payable as a fee by the firm concerned. The FSA has said that firms will be “provided with an indication of the costs expected to be incurred by the appointment of the Skilled Person, before the work begins”, but the accuracy of these estimates will be of concern to the firm, particularly where it has no say in the negotiation of fees.

For C1 firms, the FCA will carry out a firm-by-firm business model and strategy analysis in the context of the markets they operate in and for C2 firms, the FCA will take a group of similar firms in the same industry and will identify common risks. C1 and C2 firms will be assessed on a continuous two-yearly cycle.

For C3 firms, the FCA will look at a sample of firms’ business models across a sector: the FCA will examine some C3 firms’ business models and strategies, focusing on firms that are outliers compared to their peers, looking mainly at how the business is run and controlled. C4 firms will have their business models assessed but this will be a lighter assessment still. The FSA had already started to use this approach, known as the “Revised Approach to Small Firms Supervision”, which builds on work with smaller firms to assess how they achieve the six consumer outcomes in the Treating Customers Fairly initiative. The FSA is currently developing a risk-profiling tool to assess the risk to consumers that smaller firms could pose. All firms deemed to be high risk and around 25% of firms deemed to be medium-high risk will have a face-to-face interview.
3.3_The prudential mandate

As explained above, the FCA will be responsible for the prudential supervision of firms which are not subject to prudential supervision by the PRA. The PRA’s general objective under the Act of “promoting the safety and soundness of PRA-authorised persons” is to be met by “seeking to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system”.

Consistent with this, HMT’s Paper and the FCA Position Paper are clear that the FCA will not seek to build a zero failure regime. Instead, the FCA will – in the vast majority of cases – conduct prudential supervision on a “gone concern” basis, seeking to ensure that when firms fail, they do so in an orderly fashion. Systemic firms will continue to be closely supervised on a “going concern” basis.

Journey to the FCA states that the general approach will be to manage failure when it happens and ensuring that client assets are protected without adversely affecting consumers. As mentioned above, the type of supervision will depend on the nature of the firm, with firms classified into different prudential categories (prudentially critical firms (CP1), prudentially significant firms (CP2) and prudentially insignificant firms (CP3)).

- For CP1 firms, there will be a full review of the Internal Capital Adequacy Assessment Processes (ICAAP) and Individual Liquidity Adequacy Assessments (ILAA) and a review of the firm’s risk management practices where they are subject to the Capital Requirements Directive (CRD).

- For CP 2 firms, the FCA will undertake very limited going-concern supervision and only undertake a review of ICAAP and ILAA if they are Markets in Financial Instruments Directive investment firms subject to the CRD. Most of the FCA’s supervisory focus will be on satisfying itself that the wind-down plan is achievable and that the firm holds a minimum level of financial resources to fund an orderly wind-down.

- For CP3 firms, the FCA will monitor them according to minimum requirements and only step up supervision when a firm is close to failure or failing.

In the event of insolvency, the tools available to the FCA include normal administration (on failure of most smaller firms that do not hold client assets), the special resolution regime (subject to consultation with the Treasury, this may be extended to cover investment firms and other bodies and could be used if an investment firm fails to meet its threshold conditions) and the special administration regime (used for investment firms that hold client assets).
3.4_The wholesale and market regulation mandate

As noted above, the FCA’s operational objectives include (to paraphrase) discharging its functions in a way which promotes effective competition in the interests of consumers in financial markets and protects and enhances the integrity of the UK financial system.

Many of the comments made above in relation to the FCA’s conduct mandate will be relevant to its approach and renewed focus on the wholesale markets (a catch-all term used to describe how market participants interact on banking, insurance or securities markets, and the systems and controls which govern relationships with non-retail clients). Martin Wheatley draws attention to the conduct seen on LIBOR and the lack of integrity in setting rates, which is reinforced in Journey to the FCA:

“Poor wholesale conduct is not a victimless act simply because it takes place between sophisticated market participants, and it is not limited to criminal behaviour such as fraud or market abuse. It also captures a wide range of activities that exploit differences in expertise or market power to undermine trust in the integrity of markets or cause harm to retail consumers.”

The FCA Position Paper makes clear that the FCA will apply a risk-based approach to market supervision, will seek to promote competition in markets as a means of promoting their safety and will deploy the enhanced credible deterrence strategy to such markets. As described in the FCA Position Paper, safe markets are ones which are efficient and resilient, have a market infrastructure which is sound and well-run and where market participants have confidence in the reliability of the price formation process and the execution of trades. The FCA Position Paper refers to the “concentration of resources” on those markets which have a “clear, direct and immediate link to wider confidence in the financial system”.

Interestingly, while commenting that the product intervention powers will generally not be appropriate for use in the context of wholesale business, this possibility is not ruled out. In HMT’s Paper, the Government stated that there “may be circumstances in which it may be necessary to make product intervention rules for market integrity reasons”. Similarly, the FCA Position Paper refers to the possible need to “[reach] up the distribution chain, where appropriate, to intervene in wholesale activity where this could be the source of significant retail detriment”. This position was emphasised in Martin Wheatley’s speech on 20 November 2012, where he stated that “successful early intervention would require [the FCA] to place wholesale markets under greater scrutiny… at all stages of the transaction”.

Unlike its predecessor, the FCA will be willing to intervene in a greater range of client relationships (professional and sophisticated clients) in the wholesale markets, particularly where there is poor conduct or where the FSA identified that one party warrants more protection than the other. This shift towards a more intrusive, robust regulation for sophisticated clients will entail increased data gathering in specialist areas and early intervention where necessary. The FCA will also increase the intensity of its supervision of sponsors in regulated markets and will propose new rules to ensure that corporate governance structures cannot undermine the UK listing regime. For recognised investment exchanges, the Act allows for simplified procedures for directing or removing recognition, powers to require the appointment of skilled persons and the ability for the FCA to levy financial penalties and issue public censures.
The Financial Conduct Authority – An overview

The FCA is under a duty to “have regard to the importance of taking action intended to minimise the extent to which it is possible for a business (…) to be used for a purpose connected with financial crime”. The curtailment of financial crime is also part of the FCA’s integrity objective.

The FCA will deploy a risk-based approach to tackling financial crime, focusing its resources on those firms which are particularly exposed to the risk of financial crime. The FCA Position Paper states that the FCA will give greater priority to the minimisation of harm to consumers (which we think in this context means retail consumers) rather than to firms as victims of financial crime.

3.5_The financial crime mandate

Consistent with the FCA’s approach to supervision more generally, its approach to tackling financial crime will focus on intelligence gathering and thematic work to identify threats, and will enhance the FSA’s existing credible deterrence strategy. Firms will be expected to play their part in reducing the scope for financial crime and the FCA will supervise whether firms are meeting their legal and regulatory obligations.
4_FCA statutory powers, accountability and possible challenges

4.1_Statutory powers of the FCA

In addition to a change of approach, the Government is to adopt secondary legislation to provide the FCA with “a range of new tools” to support its role as a regulator.

Consumer credit powers

The Act has introduced new powers of the FCA to make rules that limit loan charges on consumer credit agreements. The sectors which may be subject to this power are those that involve unsecured short-term lending. In these sectors, the OFT report into high cost credit in 2010 found that consumers lacked choice, price competition between suppliers was minimal and consumers paid more than they should because they did not shop around. All of these factors mean that these sectors (predominantly payday lending) are fertile ground for excessive pricing and consequently the Act provides a capping power for use by the regulator.

New section 137C of FSMA gives the FCA the power to prohibit firms from entering regulated credit agreements with charges (by way of interest or otherwise) that exceed a “specified amount”. Although this provision will permit the FCA to set a maximum rate cap that applies to all lenders or to set lender-specific rate caps in particular situations, the Government has concluded that, at present, a variable total cost of credit cap is not the way to address consumer detriment in the payday lending market in the short term. However, this remains available as a solution on the future.

Similarly, the FCA has powers under new section 137C of FSMA to make rules that prohibit a firm from entering a regulated credit agreement that remains in force after the end of a specified period. This captures the practice of rollovers, which have been used by some players in the payday loans industry to extend credit at a high level of interest for a longer period than was specifically anticipated in the original agreement between the borrower and lender. Under the amendment the FCA will have a specific power to impose a limit on the overall duration of the rolled-over agreement and a limit on the number of rollovers that are permitted.

The OFT has recently published its compliance review of Payday Lending which found widespread non-compliance with the CCA 1974, other legislation and OFT guidance. The report identifies Payday Lending as a “top compliance and enforcement priority”, and new powers in FSMA will allow the FCA to pursue this and other enforcement priorities. In addition, the FCA will have other powers at its disposal – such as the new product prohibition power – to deal with loans that it considers harmful to the consumer.

Benchmark setting powers

FCA chief executive designate Martin Wheatley conducted a review of London Inter-Bank Offered Rate (LIBOR) in September 2012 in the wake of allegations of rate fixing. One of his central proposals calls for an independent administrator of LIBOR rather than the British Bankers’ Association, which will be monitored by the FCA.

On 17 October 2012, the Government accepted the recommendations from the Wheatley review in full.

New section 137F of FSMA introduces a power of the FCA to make general rules that require firms to take specified steps in connection with setting benchmarks (defined in new section 22 of FSMA as publicly available indexes, rates or
prices determined by reference to the state of the market). The Act also permits the introduction of three new regulated activities connected to setting benchmark rates:

– providing information or opinions to another to determine a benchmark (new section 24F of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001);

– administering the arrangements for or collecting, analysing or processing information or opinions for determining a benchmark (new section 24G of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001); and

– determining or publishing a benchmark or connected information (new section 24H of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001).

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2013 currently only introduces two new regulated activities, that of providing information in relation to a specified benchmark and that of administering a specified benchmark.

The FCA’s new powers are bolstered by the introduction of a new criminal offence, punishable by a maximum of seven years imprisonment, under section 91 of the Act for persons making false or misleading statements in setting a benchmark and for persons engaging in a course of conduct which creates a false or misleading impression as to the price or value of any investment or the interest rate appropriate to a transaction.

Product intervention powers

The FCA will benefit from a new power to make temporary product intervention rules, for example to block a product launch, require withdrawal of a product or provide that contracts breaching product intervention rules are unenforceable, where those rules “appear to be necessary or expedient”. Such rules could remain in force for up to 12 months without consultation.

The Government noted in a February 2011 consultation that the new product intervention power is unlikely to be appropriate in relation to the protection of professional or wholesale customers and this position was strongly supported by respondents. Building on these responses, the Government decided to make explicit in new section 137D of FSMA that the FCA may not use its new product intervention power to advance the market integrity objective by linking the new power to the consumer protection and competition objectives. However, the Government believes that there may be circumstances in which it would be necessary to make product intervention rules for market integrity reasons, and therefore it has provided the Treasury with an order-making power to extend the power to cover the FCA’s integrity objective, subject to the affirmative procedure in Parliament. This is controversial and many believe that the power should be strictly limited to retail consumers only.

In addition to the power being tied to the consumer protection objective, the definition of “consumer” in new section 1G of FSMA could mean that the power will be used in relation to market participants who would traditionally fall outside the retail sphere. The FSA has acknowledged the wide ambit of the term “consumer”, noting in the FCA Position Paper that “consumer” can include various kinds of wholesale consumers including hedge funds and stockbrokers executing orders on behalf of other clients.

The FCA Position Paper goes on to state that the duty to protect retail consumers will necessitate a focus not only on firms’ conduct towards them directly, but also on the knock-on effects and adverse implications that may result from activities in retail-related wholesale markets. This “could include reaching up the distribution chain, where appropriate, to intervene in wholesale activity where this could be the source of significant retail detriment”. Some trade bodies have argued strongly that the FCA should protect retail consumers by taking regulatory action at the point of distribution.
Safeguards in the Act are limited (e.g. the publication of a “statement of policy” on the FCA’s proposed temporary product intervention rules, a time limit on temporary product intervention rules of 12 months and a prohibition from making further temporary rules which are substantially the same as temporary rules which have lapsed within 12 months).

Some have argued that the “necessary or expedient” test in new section 137D(1) of FSMA is too wide and should be reconsidered to introduce a higher threshold for the use of the power such that it can only be used in exceptional circumstances likely to result in significant consumer detriment. A further suggestion (although not taken forward) was that firms should have the right to make representations to the FCA on a decision to exercise the product intervention power before it takes effect and that the FCA should be required to take those representations into account (as opposed to “have regard” to them).

The right balance needs to be struck between the use of regulatory powers to prevent consumer harm and allowing firms the freedom to develop innovative products. The proposed new powers for the FCA are very wide-ranging and the FCA will have a considerable degree of discretion when determining whether to invoke its powers to ban or temporarily impose requirements on products. The uncertainty this creates is unhelpful. Not only does it hinder development of new products, the resulting legal uncertainty will have an impact on existing contracts and the role, responsibilities and liabilities of different firms in the distribution chain.

There is a clear need for guidelines defining the circumstances and method for utilising these powers in order to provide the market with a solid framework within which to operate when designing new financial products. For example, the Government has stated that it expects the FCA to use the power “where it is appropriate and proportionate” but there is currently no provision to this effect in the Act. It may also be helpful if the guidance identified the “objectionable characteristics of a product” in order to provide certainty. Others query whether the FCA will necessarily have the expertise to recognise a bad investment, although it is possible that the proposed new business and market analysis team at the FCA (a resource not available to the FSA) will help. A further concern is that ill-thought-out interventions could ultimately restrict consumer choice and competition.

Some remaining questions are:

– How will product intervention fit with EU “maximum harmonisation” provisions and the Government’s commitment not to “gold-plate” EU law? Will the Government consider product intervention rules in the light of powers that the European Securities and Markets Authority will have to ban certain products to remove regulatory arbitrage?

– Will it be possible for some firms to circumvent the product intervention mechanisms by re-locating offshore and ‘passporting’ in and, if so, what can be done to prevent such practices?

– How can the FCA ensure compatibility of its product intervention power with its pro-competition objective?

The FCA will also continue with the FSAs proposal to turn existing guidance on product provider responsibilities into rules, to ensure that there are regulatory obligations that cover the entire distribution chain. Providers will be expected to have procedures to assess their target market, perform adequate stress testing and manage product risks to customers.

Power to disclose the commencement of formal enforcement action – warning notices

As discussed in the section above on the FCA’s approach to regulation, further enhancement of the FSAs recent strong activity in enforcement is listed in the FCA Position Paper as one of the main elements of the FCA’s approach. Highlighted as part of this is the new power for the FCA to publish the fact that a warning notice has been issued.

The Act provides that the FCA (and the PRA) will have a new power to publish details about warning notices issued at the start of enforcement actions in relation to disciplinary proceedings, the effect of which is compounded by a simultaneous reduction in the minimum representation period prior to issue of warning notices from 28 to 14 days (in new section 387(2) of FSMA).
The Government sees the publication of details of warning notices to be a key tool in the credible deterrence strategy; in its view, greater disclosure of information could have a beneficial impact on strengthening the dissuasive effect of disciplinary actions and in improving the transparency of the process.

This new power is as controversial as the product intervention proposals because of the significant reputational damage that could be caused to firms. Publication would take place before a disciplinary process had been completed and before a firm or individual had had an opportunity fully to put their case with the benefit of full disclosure from the regulator. Commentators have argued that the proposal disregards fundamental legal principles and principles of natural justice.

The Government recognises that “the majority” of respondents were opposed to this new power but maintains that the proposed safeguards are adequate, in particular because:

– the power is not expressed as a duty;

– the regulator must consult the person to whom the notice is given or copied before making any disclosure with recipients to be given seven days to respond; and

– the regulator must consider whether publication would be unfair to the person to whom the warning notice relates.

The proposed safeguards are not, however, satisfactory. While the power to publish is discretionary, this simply introduces another area of uncertainty for firms and the requirement to consult is not a requirement to obtain a firm’s consent. In relation to the “unfairness” safeguard, the FCA should consider the potential impact on market stability of such an announcement, and the potential reputational damage that may occur. But this alone is not enough. Although the legislation provides for the issuance of a “notice of discontinuation” it is unlikely that this would repair any damage that had been caused by publication of a warning notice. Information that is published is likely to be misinterpreted by consumers, the media and market participants.

Some have argued that firms should have the express right to comment on the notices and whether publication is appropriate (as opposed to simply being consulted) and that the FCA should be required to consider and take into account those comments. If the FCA publishes a notice in spite of comments that it is not appropriate to do so, it should be required to explain why it is fair to proceed with publication. The FCA should also be required to summarise the defences or mitigation advanced by the firm or individual in order to ensure that the summary that is published is balanced. It has been suggested by more than one trade association that to avoid the “unfairness” test being a meaningless matter of opinion, a further safeguard should be to require clearance from the Regulatory Decisions Committee before the exercise of these powers in individual cases. Another safeguard could be a statutory requirement for the FCA to publish a Code of Practice covering the drafting of the statement, related press statements and media briefings, and the necessity for the FCA to issue a prominent statement if the case is closed or not proven.

A fundamental issue raised by some is whether the proposed power would have the beneficial effect intended or whether it might have an adverse impact on the UK’s financial markets. Whilst the early notification would alert the markets/investors to action being proposed by the FCA, it would by its nature not provide specific details or analysis. This, in turn, could cause significant market uncertainty, threaten market stability, and negatively affect the reputation and viability of issuers and investment firms concerned. The power may also lead to a less open and more confrontational relationship between the FCA and firms and result in the disciplinary processes becoming more costly and time-consuming at an early stage, as the authorised entity would seek to resist the early notification, if necessary through the courts.

One answer may be to draw a distinction in the Act between cases where urgent publication is necessary in the interests of consumer protection (e.g. in cases involving systemic mis-selling) and other enforcement cases where the cost to firms of public disclosure may outweigh any benefit.
Power to direct that misleading financial advertisements are withdrawn or amended

A further new power for the FCA (under new section 137S of FSMA) is to direct firms to withdraw or amend misleading financial promotions with immediate effect and to announce that they have done so. The publication of this information is another of the controversial publication powers given to the FCA. The Government maintains that the duty to publish will increase the visibility of the regulator's activities, provide firms with greater clarity as to good and bad practice, and engender better practice across the industry.

HMT's Paper claims that there was widespread support for this new power and the Government believes that this new power will be an important addition to the FCA's toolkit. However, the Government has accepted that there must be safeguards to this new “mini-enforcement” process: the FCA must alert a firm to its proposed course of action and provide a short period to make representations. In addition, there will be some discretion over the content of any publication.

Concerns have been expressed as to whether the FCA should be under a duty to publish directions made under this new power and as to whether the safeguards are sufficient. Some feel that it is wholly wrong to require, for example, the publication of a direction which the FCA decides, after hearing representations, should be revoked. Furthermore the Act provides that if a financial promotion has not yet been published, the FCA will be able to give a direction if it considers that the promotion “is likely to” contravene financial promotion rules. Some firms believe that this formulation is too broad and that the Act should be amended so that the FCA can only give a direction in relation to a financial promotion that has not yet been published if it “would” contravene financial promotion rules. An additional safeguard would be to require the FCA to include a fair summary of representations made and to give the firm an opportunity to escalate disagreements, particularly in cases where the publication may cause significant reputational or legal risk to the firm.

Investigations and enforcement powers

HMT's Paper confirms that the FCA will have the same information-gathering and access powers as the FSA, but there will be some changes. In particular:

- the FCA will be able to retain original documents;
- the execution of warrants will be carried out on a statutory footing in a uniform way;
- there will be a power for the owner of the documents to apply for their return – this will replace the current three-month limit; and
- the FCA (and the PRA) will be able to appoint a skilled person to collect and update information where it considers that an authorised person has contravened a requirement in the rules to collect and keep up to date that information. The Government is proceeding with its proposals to give extended powers to the FCA to require a listed issuer to commission a skilled person's report and this power will also now apply to sponsors.

Of these, only the “skilled person reports” power in relation to listed issuers and sponsors appears to have attracted negative comment, largely because of the potentially high cost. The FSA suggests that the use of Section 166 reports have increased from 17 in 2005/06 to 140 in 2010/11, at an average cost to the subject of £270,000 (though some cost as much as £500,000). Some argue that the FCA should be aiming to build its own in-house competence to undertake this type of report, rather than relying on external parties.

More generally, the FCA will continue with the FSA's work on financial crime and will have the power to impose penalties for market abuse in the same way as the FSA. It will also have the power to undertake criminal prosecutions for insider dealing and market manipulation (other than in Scotland).
**Sharing information**

It is worth noting the new duties on the FCA to share information which could be used for enforcement purposes. Under new section 232A of FSMA the FOS is required to pass to the FCA any information which might be of assistance to advancing one of more of the FCA's operational objective. The draft MoU between the FOS and the FSA puts a requirement on the FCA to have regard to information it receives from the FOS in fulfilling its objectives.

Linked to this is the requirement under new section 230A of FSMA for FOS to publish reports of determinations unless the ombudsman considers it inappropriate to do so. The legislation states that the published information must not include the name of the complainant or any particulars which are likely to identify the complainant, unless the complainant agrees.

The FOS published a Consultation Paper on 9 September 2011 seeking views on the practical issues involved in such publication. The FOS indicated that it intends to publish actual final determinations rather than summaries of determinations. Of particular note is the fact that while the legislation is silent on the question of whether the identities of respondent firms should be disclosed, the FOS’ “initial view” is that it should not delete the name of firms involved. The reason given is that the required redaction would be too extensive and more significantly that “there is inevitably considerable public interest in the identity of the business in many cases… and attempting [redaction] may only fuel public speculation – and sometimes erroneous reporting”. The FOS has decided not to make any exceptions for smaller businesses. The Paper indicates that the FOS will be prepared to use its discretion not to publish where there may be information about a business practice or procedure that is genuinely commercially sensitive or where publication of the full decision might prompt or inform criminal activity, or might frustrate a criminal or regulatory investigation. The FOS will consult with firms as well as consumers about the proposals but appears to rather prejudge the process by stating that with regard to concerns about reputational damage “in so far as the decision accurately records actual events, then the reputational damage may be deserved”. The FOS also dismisses concerns that publication of information would enable claims-management companies to “target” relevant businesses and topics.

**Power to initiate an enhanced referral to the OFT**

As discussed in the section above on the FCAs objectives, while the FCA will not have as a primary objective the promotion of competition, it will have a duty to promote competition in so far as this is compatible with its strategic and operational objectives. In order to help it fulfil its mandate, the FCA has a power, under new section 234H of FSMA, to initiate an enhanced referral to the OFT where it has identified a possible competition issue that may benefit from technical competition expertise or require recourse to powers under competition law that sit with the competition authorities. The OFT has a statutory duty to respond to such a referral within 90 days.

In adopting this measure, the Government has rejected both options set out in its February 2011 consultation paper:

- the FCA should have limited concurrent powers (e.g. to make a market investigation reference to the Competition Commission); or
- powers should be conferred on an appropriate body (such as the Consumer Panel of the FCA) to trigger the super-complaint process.

What we are left with is something inbetween – similar to powers under the super-complaint system, but not as strong as concurrency (even in a limited form).

Many respondents to the consultation raised concerns that giving the FCA any kind of concurrent powers would be inappropriate given the clear message from the Government that the FCA is intended to be a “behavioural” rather than “economic” regulator. To enable the FCA to make a market investigation reference directly to the Competition Commission (and thus bypassing the “filter” of the OFT) would require it to have a certain degree of expertise in assessing competition issues, which many believe the FCA will not have. While it can be questioned whether the enhanced referral process will lead to longer investigations, as the OFT will have to review and respond to the FCAs referral, then potentially carry out a market study before any market investigation reference to the Competition Commission is made, this is perhaps preferable to the FCA taking a decision itself on which issues are important enough to warrant a two-year market investigation, leaving no discretion to the competition authorities.
This revised approach has been welcomed by many industry bodies as striking the correct balance between the FCA and the OFT/Competition Commission. As recognised by the Government, the new power “will significantly add to the FCAs toolkit while respecting the roles and expertise of the competition authorities”.

It is also arguable (although few respondents raised the issue) that giving a body within the FCA the status of super-complainant would be an inappropriate way to enhance the competition powers of the FCA. The super-complaint powers under the Enterprise Act 2002 were designed as a fast-track system to enable designated consumer bodies to bring to the OFT’s attention any features of the market that appear to be significantly harming consumers. Bodies such as the Consumers’ Association (Which?) have been granted such status. However, the FCA will be a statutory body fundamentally different from a consumer organisation with a much wider-ranging mandate. It therefore seems sensible that the Government is proposing to create a mechanism of referral distinct from the super-complaints system. While on its face the enhanced referral power seems very similar to the powers enjoyed by super-complainants (i.e. requiring the OFT to review and respond to a referral within 90 days), the wording in the Act is noticeably wider. It enables the FCA to ask the OFT to consider whether any feature or features of a market in the UK for financial services may “prevent, restrict or distort competition”, and is not limited by reference to features that might harm consumers. In fact the wording mirrors the provision in the Enterprise Act which gives the OFT the power to make a market investigation reference to the Competition Commission, tying in with the principle that the FCA will form an additional layer of scrutiny of the financial services markets on top of the competition authorities.

Effective implementation of the enhanced referral power raises two key challenges. First, while it will not need to be an “expert” in matters of competition per se, the FCA will arguably need to be more familiar with competition issues than the FSA needed to be. As noted by Hector Sants: “The Government is not expecting the FCA to become an economic regulator but is expecting it to utilise its powers to make judgements on pricing issues where they relate to fairness. Delivering on this mandate will require a step change relative to the FSA in the FCAs technical skills and philosophy.”

Secondly, there will need to be clear guidelines for cooperation between the FCA and the OFT (or the new Competition and Markets Authority, once it is established following the wider reform of the competition regime). Presumably the OFT will continue to monitor the financial services markets for any evidence of anti-competitive conduct or market features, but it would be helpful for there to be published guidance on how (if at all) the authorities intend to minimise duplication of efforts between the OFT and FCA.

Finally, it will be interesting to note the extent to which, if adopted in its current proposed form, the FCA will utilise its power to make an enhanced referral to the OFT. In its consultation on the reform of the UK competition regime, the Department of Business, Innovation and Skills noted that one of the main criticisms of the regime which gives concurrent competition enforcement powers to economic regulators (Ofcom, Ofgem, Ofwat and the ORR) was that they were unwilling to use their competition powers, preferring instead the more familiar territory of their regulatory powers. In giving the FCA a power to refer, rather than enforce, it is hoped that the FCA will be encouraged to pass on competition matters which it believes may be problematic, ultimately resulting in markets that work better for consumers.

Consumer redress powers

The new FSA power to establish consumer redress schemes is given to the FCA. The Government considers that it would be “a powerful tool”. As stated in HMT’s Paper there will be a duty on the FCA to state publicly whether an issue brought to its attention (by the FOS or consumer groups) is causing mass detriment. At the same time, where appropriate, the FCA will set out what action it intends to take to address the issue. While the FCA will be well placed to deal with mass claims of a regulatory nature, there are a number of technical issues still outstanding.
Threshold Conditions

New threshold conditions (TCs) will be implemented under new section 55C of FSMA. The most significant change to the current TCs is that there will be separate sets of TCs for firms regulated by the FCA, PRA and for dual-regulated firms. The draft Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013 sets out these TCs, which will provide the basis for triggering certain powers of intervention in relation to a firm, including the power to vary or cancel permission, and will also determine the outcome of applications for permission or authorisation.

Linked to the focus on the business strategies of regulated firms, the FCA will apply a new TC, looking at the suitability of a firm’s business model to address risks that might be posed to a firm, its customers, and the integrity of the UK financial system. For dual-regulated firms, this TC requires the firm’s business model to be “suitable” for its regulated activities having regard to the FCA’s operational objectives. For FCA-regulated firms, this TC will take into account whether the business model is compatible with the firm’s affairs being conducted in a sound and prudent manner, in addition to considerations of whether it is in the interests of consumers and whether it will affect the integrity of the UK financial system. Journey to the FCA has emphasised that firms will be obliged to submit an “appropriate, viable and sustainable business model, given the nature and scale of the business that they intend to carry out”; the model must demonstrate adequate contingency planning and make clear how it will meet the needs of clients and customers and not place them or the integrity of wider financial system at undue risk.

There is also a new reference in the suitability TC for both the FCA and dual-regulated firms requiring those managing the affairs of the firm to act with probity to satisfy the FCA that the firm is fit and proper. In assessing this the regulators will consider the entirety of the firm’s board and non-board senior management. Where managers and directors do not act with probity their firms can be held to account by the regulators (in addition to action taken against a manager or director via other means, such as through the approved persons regime).

FCA-regulated and dual-regulated firms will also be required to comply with the “effective supervision” TC. A firm must be capable of being effectively supervised having regard to all the circumstances, including the nature and complexity of the regulated activities, the complexity of any products that the firm provides and the way in which the firm’s business is organised. There is the possibility that a smaller firm could be prejudiced from offering a product that is too complicated simply because it is one that is offered mainly by larger businesses. Unless if the product is too complicated relative to the firm’s resources and expertise, restricting a firm from offering a product may be anti-competitive if the rationale is that the firm’s peer group does not offer such products.

Similarly, it has been suggested that this TC may lead to a firm with a complex business structure being considered as unregulatable by the FCA. As firms in a free competitive market organise themselves in a different way, this would be a concern, particularly in relation to large C3 firms with no nominated supervisor but part of a flexible portfolio of supervisors. Again, it may be considered anti-competitive if a C3 firm were subject to constraints simply because the regulatory architecture had changed.

Power over unregulated parent undertakings

The framework for the supervision of financial groups is intended to apply so that the same level of oversight and supervisory powers can be applied irrespective of the legal structure of the group. The FCA (and the PRA) will benefit from a new power under Part 12A of FSMA of direction over unregulated parent undertakings that control and exert influence over authorised firms. The power will apply only where an unregulated parent undertaking is (i) a “financial institution”; and (ii) a body corporate (e.g. a company, LLP, a building society or an industrial and provident society) incorporated in the UK or with a place of business in the UK.

The current draft of the Financial Services and Markets Act 2000 (Prescribed Financial Institutions) Order specifies that financial institutions for this purpose include insurance holding companies, financial holding companies and mixed financial holding companies. In so far as Part 12A applies to parent undertakings of recognised investment exchanges (RIE) or to the Bank of England in the exercise of its functions in relation to recognised clearing houses (RCH), all financial institutions may be considered a qualifying parent undertaking (unless the
parent undertaking is itself a RIE or RCH). “Financial institution” is not defined for these purposes but will include an entity which itself provides financial services or which operates financial market infrastructure or whose business involves the ownership of, or management of, such entities.

Under the Act, the FCA can only give a direction if it considers that: (i) a direction is desirable to advance one or more of its operational objectives; or (ii) the FCA is the appropriate regulator in relation to the consolidated (or supplemental) supervision of some or all members of the group of a qualifying authorised person and the FCA considers that giving a direction is desirable for the purposes of effective group consolidated supervision. Before exercising the Part 12A power, the FCA must have regard to: (i) the desirability of exercising powers over the authorised person or recognised investment exchange rather than using the Part 12A power; and (ii) the principle of proportionality. It is therefore envisaged that use of this power will be relatively rare and is not intended to address concerns that the regulator may have in relation to the unregulated parent undertaking itself (which are already covered within the scope of regulation of the controller regime).

Miscellaneous new powers

– Power to sanction sponsors by imposing unlimited penalties and/or suspensions or restrictions on sponsor activities (under new section 88A of FSMA).

– Power to extend the limitation period for taking action for breaches of the Part 6 rules, which include the listing rules, from two years to three years (under new section 88A of FSMA).

– Power to give the UK Listing Authority (UKLA) the power to make rules for, and impose sanctions on, primary information providers such as regulatory information services (under new sections 89P and 89Q of FSMA).

– Power to allow the UKLA to discontinue or suspend a listing at the request of an issuer without following the warning notice and decision notice procedure (under new section 88E of FSMA).
4.2_Accountability of the FCA

Journey to the FCA indicated that it is the FCA’s duty to act in a way that is “as open and accountable as possible”. This statement goes further than any specific provision in the Act itself, which imposes a number of lower level duties to deliver good governance, a means of challenge and value for money.

Governance

The Act imposes an obligation on the FCA to have regard to generally accepted principles of good corporate governance as is reasonable (new section 3C of FSMA). This watered-down duty does not make clear which principles are generally accepted and to what extent the FCA will need to adopt them (as opposed to merely having regard to them). For example the duty does not specify any obligation to observe the relevant parts of the UK Corporate Governance Code where it is able to do so in order to ensure effective governance and accountability.

In terms of board structure, the Act sets out that the FCA’s board composition, which will be made up of executive and non-executive members and its role will be to challenge the executive. New Schedule 1ZA of FSMA sets out the requirements for establishing the governing body of the FCA: it will consist of a chair and chief executive both appointed by the Treasury, the Bank’s Deputy Governor for prudential regulation as a non-executive member, 2 non-executive members appointed jointly by the Secretary of State and Treasury and at least one additional member appointed by the Treasury who may be an executive member. The terms of service of an appointed member must be so as to secure that the appointee is not subject to direction by the Treasury, Secretary of State or any other person. The FCA will determine the remuneration of executive members and the Treasury will determine the remuneration of non-executive members.

Although there is currently no statutory provision requiring representation of all industry stakeholders on the board, with equal weight given to wholesale markets, recognised bodies and consumers, the FCA is under duty to make and maintain effective arrangements for consulting practitioners and consumers on the extent to which its general policies and practices are consistent with its general duties (new section 1M of FSMA).

The FCA is under a further duty to consider representations made by the FCA Practitioner Panel, Smaller Business Practitioner Panel, Markets Practitioner Panel and Consumer Panel (new section 1R of FSMA).

New schedule 1ZA of FSMA includes further provisions on the FCA’s governance and accountability structure, which includes:

- the requirement to publish a record of meetings of the FCA’s governing body (paragraph 10);
- the requirement to produce an annual report (paragraph 11);
- the requirement to hold and report on an annual public meeting (paragraphs 12 and 13); and
- the requirement of the Comptroller and Auditor General of the National Audit Office to examine, certify and report on the FCA’s annual accounts (paragraph 14)

Achieving the FCA’s regulatory outcomes efficiently and economically

Journey to the FCA states that the FCA will be more accountable on how it manages its costs, and the FSA is currently developing incentives and mechanisms to deliver value for money, including savings targets, delivering with reduced headcount, and further streamlining how it procures services.

The Act gives the Treasury the right to appoint an independent person to review the economy, efficiency and effectiveness with which the FCA has used its resources in discharging its functions (new section 1S of FSMA). This provides a way of holding the FCA to account for the way in which it complies with the regulatory principle requiring the FCA to use its resources in the most efficient and economic way (new section 3B of FSMA).
Publication by the FCA of performance information, particularly with respect of the use of its new powers, remains to be seen. For example, how will the different levels of engagement with the supervision teams be monitored to ensure consistent product intervention outcomes? Will the FCA publish information about the extent to which Warning Notices (about which information has been published) are subsequently discontinued or amended?

An initial indication of the mechanisms for achieving value for money, good governance and means of challenge has been set out in Journey to the FCA. The proposed criteria for assessing the success of the FCA are based on three key outcomes and the detail of measuring success against these outcomes will be set out in the FCA’s first business plan. The proposed outcomes are:

– whether consumers are getting the financial services and products that meet their needs from firms they can trust; and

– whether firms are competing effectively and do they have the interests of their customers and integrity of the market at the heart of how they run their business; and

– whether markets and financial systems are sound, stable and resilient with transparent price formation.

Complaints and regulatory failure

There will be a formal process for dealing with complaints and regulatory failure, and the FCA will be subject to freedom of information requests and audits by the National Audit Office. In particular the new regime introduces a duty of the FCA to investigate and report to the Treasury on possible regulatory failure (section 73 of the Act) and a complaints scheme which requires the FCA to investigate complaints arising in connection with the exercise of, or failure to exercise, any of the FCA’s relevant functions (section 84 of the Act).

Details of how redress will be sought are limited, particularly when the FCA wrongly makes use of its powers, such as the product intervention power. For further discussion on challenging the FCA see 4.3 below.
Judgement-based supervision brings uncertainty for firms – as regulators become more intrusive and are granted flexibility in their decision making, a key question is how the regulator will be held accountable when exercising its judgement.

The Act does not include provisions that allow firms to make representations to the FCA to dispute its decisions although, for the time being, the Regulatory Decisions Committee will continue. With the exception of disciplinary matters and those involving third-party rights with respect to warning notices, the Upper Tribunal will not be able to substitute its opinion for that of the regulator as to the regulatory action which should be taken by the regulator. The Upper Tribunal will instead be required to remit the decision to the regulator with such directions as it considers appropriate in relation to issues of fact or law, the matters to be, or not to be, taken into account in making the decision, and/or the procedural steps to be taken in making the decision. The FCA will then be required to reach a decision in accordance with such directions.

From the Government’s perspective, this reconciles the conflict between the need to ensure that those affected by supervisory decisions have appropriate rights of challenge and the fact that the regulators are best placed to determine the nature of the regulatory action which should be taken. However, from a firm’s perspective, the time, costs and publicity which sit alongside a referral may deter them from wishing to challenge supervisory regulatory decisions at first instance.

Key to the significance of this change is the difference between a disciplinary reference, (in respect of which the Tribunal can substitute its own decision, there being a merits based right of reference,) and supervisory decisions. A list of disciplinary matters is provided and includes such matters as penalties imposed for market abuse and for performing a controlled function without approval. All other matters fall subject to the supervisory remit. As a result, there will be no merits based reference in respect of the imposition of temporary product intervention rules and the decision to publish details of a warning notice, perhaps the two most controversial aspects of the proposed reforms.

Commentators have rightly questioned whether this will give authorised entities an effective means to challenge the FCA in these areas.
5_Interaction between the FCA and other authorities

5.1_Interaction between the FCA and FPC

The FPC has the authority to give directions to the FCA relating to a class of regulated person on matters relating to macro-prudential policy (new section 9H of FSMA). The FPC also may make recommendations to the FCA that relate to all regulated persons as well as to classes of regulated persons about the exercise of its functions (new section 9Q of FSMA). Any directions received by the FCA will need to be implemented as soon as reasonably practicable, while any recommendations received by the FCA will need to be implemented by the FCA on a “comply or explain” basis. As a result, the FCA will have to incorporate the FPC’s directions into its regulatory agenda, rules and policy.

The record of the interim FPC meeting on 16 March 2012 suggested that the specified set of powers of direction would not preclude the FPC from issuing a wider range of recommendations to achieve its objective. The record also states that powers of direction would more likely be suited to targeting systemic risks that varied over time, while risks relating to market structures would most effectively be mitigated through its powers of direction.

As the FPC can give directions to the FCA, its macro-prudential policy decisions (in accordance with its statutory objective to contribute to the Bank of England’s financial stability objective) will have a direct impact on firms regulated by the FCA. The influence of the FPC over the FCA will therefore be an important consideration for firms and it will be important to keep up to date with the agenda and publications of the FPC. Consequently, although firms will not have a direct relationship with the FPC, they will certainly be influenced by its policy as a result of the FCA’s implementation of the FPC’s recommendations and directions.

5.2_Interaction between the FCA and PRA

The principal focus of the PRA’s co-ordination with the FCA will be at the firm-specific level. Specific consideration will also be given to common standards and rules for risks which are directly relevant to both the FCA and PRA’s responsibilities, e.g. governance and controls.

FSMA, as amended, does not set out operational arrangements for each of the authorities, e.g. in relation to whether the PRA and the FCA will use the same reporting system. HMT’s Paper explains that the Government considers that each authority will develop its own regulatory culture and approach to engagement with firms. As a result, dual-regulated firms will have to adapt to both. It will be for the FCA and PRA to determine whether there is scope for sharing services (which we assume will follow at a later stage, closer to implementation). It will be necessary to wait to see what arrangements (if any) will be put in place by the FCA and PRA in relation to overlapping services and functions (particularly in light of the principle in FSMA that the PRA and the FCA must each use their resources in the most efficient and economic way).
Dual regulated firms

The potential areas of overlap between the FCA and PRA are most prevalent in relation to dual-regulated firms, i.e. those firms that will be subject to regulation by the FCA (in relation to conduct matters) and by the PRA (in relation to prudential matters), for example banks and building societies. It will be essential in the new architecture to ensure that a firm is not subject to conflicting rules or instructions from each of the PRA and the FCA. The Government has recognised this and it has been proposed that the FCA and the PRA will put in place arrangements for co-ordinating their operations that will impact dual-regulated firms, including:

- supervisory colleges;
- close cooperation during the authorisation process;
- provision for the FCA to notify the PRA before taking enforcement action;
- consideration of how best to put in place common standards and rules for risks which are directly relevant to both authorities’ responsibilities;
- co-ordination in setting rules and policy of each of the PRA and the FCA;
- co-ordination in relation to the regulation of with-profits insurance; and
- a requirement that each of the FCA and the PRA must include an account of how they have co-ordinated and co-operated in their annual accounts.

Secondary legislation may also require that a matter relating to dual-regulated firms is a responsibility of the FCA or the PRA.

It is expected that much of the detail on how the PRA and the FCA will co-ordinate the regulation of dual-regulated firms will follow the date of implementation of the new architecture and develop as a matter of practice. See, for example the description of the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order at paragraph 2.1 above.

Provisions in FSMA relating to co-ordination between the FCA and PRA

Statutory duty to co-ordinate

The Act contains a statutory duty to ensure co-ordinated exercise of the functions of the FCA and the PRA (in new section 3D of FSMA). This includes consultation between the FCA and the PRA where a proposed exercise of a function of one of the FCA or the PRA may have a material adverse impact on the other regulator advancing its objectives.

The duty to co-ordinate also extends to information sharing. However, this duty does not apply if it would not comply with the relevant regulator’s objectives or if it imposes a disproportionate burden on a regulator.

The FCA Approach Paper indicates that information gateways will be established between the PRA and the FCA to allow the free flow of information where needed.

Duty to establish and maintain an MoU

The FCA and the PRA, under new section 3E of FSMA, must publish and maintain a MoU which covers how they will exercise their duty to coordinate and exercise their functions that relate to authorised persons and similar or related functions that each regulator has. This will be of particular interest to dual-regulated firms as it will detail how the FCA and the PRA will co-ordinate applications for authorisation, other applications for approvals and changes to scope permission, and also information sharing. Currently, a draft MoU has been published, which provides that the relevant prudential regulator will lead and manage a single administrative process for authorisation and the PRA will seek consent of the FCA to authorise dual-regulated firms.

Directions from the PRA to the FCA

The PRA has the power to give directions to the FCA to require it to refrain from taking certain action under new section 3I of FSMA, where it proposes to take action in relation to dual-regulated firms (or a class/particular dual-regulated firm). However, the exercise of this power is
limited to circumstances where the PRA considers that the FCA’s exercise of its powers may threaten the stability of the UK financial system or result in the failure of a PRA regulated firm in a way that would adversely affect the UK financial system. We envisage that this power will therefore have limited application, except in times of crisis for a particular firm or the market more generally. The mere existence of the power sends a signal of which authority is expected to be dictating the tone of regulation.

Cross-membership of boards

The Bank of England’s Deputy Governor for prudential regulation will sit on the board of each of the PRA and the FCA and so the Act provides for cross-membership of these authorities. Also, the CEO of each of the PRA and FCA will be appointed *ex officio* to the board of the other regulator specifically to support the statutory duty on the regulators to co-ordinate.

5.3 Interaction between the FCA and the Bank of England

The FCA (and the PRA) must take appropriate steps to co-operate with the Bank of England in relation to its pursuit of its financial stability objective (pursuant to new section 3Q of FSMA). The Bank of England also has a specific statutory power (in new section 9Y of FSMA) to give a direction to the FCA to provide information or documents to the Bank if required in connection with the exercise of its functions in pursuance of the financial stability objective. The Bank of England’s macro-prudential policy will therefore impact on the FCA’s policy.

As the Bank of England is responsible for regulating central counterparty recognised clearing houses and settlement systems, and the FCA is responsible for regulating market infrastructures, it is proposed that there will also be cooperation and information sharing between the FCA and the Bank of England in relation to market infrastructures supporting trading, clearing and settlement. The extent of co-operation and information sharing between the FCA and the Bank of England are set out at a high level in the draft MoU between the FCA and the Bank of England. Broadly, the two organisations will seek to consult one another and share information where to ensure that each regulator is able to advance its objectives. For dual-regulated entities, for instance, there will be regular exchanges of information and the two organisations will notify each other when imposing requirements or taking other enforcement action.

5.4 Interaction between the FCA, FOS, FSCS and Money Advice Service

In pursuing its consumer protection objective, the FCA will work closely with the FOS, the FSCS and the Money Advice Service. MoUs will be entered into between the FCA and these bodies to govern co-operation between them. For example, it is proposed that the FCA and the FSCS could work together on firm specific as well as general contingency planning for potential failings of firms in the future. In addition, information sharing mechanisms will mean that the FCA will be able to make full use of the information held by the FOS on firms’ treatment of their customers and handling of their complaints.
5.5_Interaction between the FCA, OFT and CMA

In promoting competition the FCA will have a range of tools to improve consumer outcomes, such as rule-making powers and market-wide interventions, covering suppliers of competing or substitute products. The FCA will conduct market studies, design pro-competitive remedies, and will balance the impact on competition with new measures it proposes for dealing with other problems using an enhanced approach to its market failure analysis. However, where causes of poor consumer outcomes fall outside the FCA’s remit, it will use its power to refer problems to the appropriate competition authorities. Journey to the FCA has stated that the FCA will strengthen the way it works with the OFT and the future Competition and Markets Authority. In 2013 the FSA intends to publish draft Principles of Co-operation that set out how the FCA and the OFT will develop their respective roles and how they aim to achieve consistency.

5.6_International coordination

It is proposed that the Treasury, the Bank of England, the PRA and the FCA will enter into an MoU on international coordination. This will be necessary to ensure effective co-ordination with the European Supervisory Authorities and other national regulators. In January 2012, the Government published its MoU on international organisations, which aims to address the challenge which the FCA, Treasury, Bank of England and PRA will face when trying to present a coherent and consistent line with the UK’s international partners in different fora (for instance the Basel Committee on Banking Supervision, the Financial Stability Board, EU working groups, the European Supervisory Authorities and so on).

The MoU establishes an International Coordination Committee which is responsible for ensuring that UK authorities act in accordance with the principles in the MoU, which seek to ensure that there is openness, cooperation and coherence where UK authorities deal with their international counterparts. Schedule 3 of this paper sets out the international bodies in which the FCA has a role or a potential interest.

In addition, the MoU to be entered into between the FCA and PRA will detail how they will co-ordinate relationships with competent authorities outside the UK and with the European Supervisory Authorities.
6_FCA’s interaction with the European System of Financial Supervisors (the ESFS)

This section of the paper will look at how the FCA will coordinate its functions with the new European Supervisory Authorities.

6.1_The European System of Financial Supervision

The European System of Financial Supervision (the ESFS) came into force on 1 January 2011. The ESFS comprises:

– a European Systemic Risk Board (the ESRB), a body charged with macro-prudential supervision;

– three European Supervisory Authorities (ESAs), which supersede the old Level 3 committees, and have increased regulatory powers:
  – a European Banking Authority (the EBA) based in London – taking over from CEBS;
  – a European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt – taking over from CEIOPS;
  – a European Securities and Markets Authority (ESMA) based in Paris – taking over from CESR;

– a Joint Committee of the European Supervisory Authorities (Joint Committee); and

– the competent or supervisory authorities in the Member States.

6.2_The ESAs

The ESAs operate alongside national regulators, carrying out a micro-prudential role with the aim of strengthening consultation at EU level, harmonising both rules and regulatory enforcement action. The ESAs key powers include:

– imposing a temporary ban on financial activities;

– investigating alleged breaches of EU rules;

– taking binding decisions in emergencies;

– arbitrating in disputes between national supervisors;

– playing a coordinating role within colleges of supervisors;

– undertaking peer review;

– directly supervising credit rating agencies (ESMA only);

– requiring information to be passed to them that is necessary for discharging their responsibilities; and

– issuing guidelines and recommendations addressed to competent authorities or financial market participants.

The ESAs have binding decision making powers vis-à-vis national authorities, and in certain circumstances vis-à-vis
financial institutions too. ESAs have the power to address decisions directly to national competent authorities:

– where the ESAs are arbitrating between national authorities both involved in the supervision of a cross-border group and where they need to agree or coordinate their position;

– where a national authority is incorrectly applying EU Regulations; and

– in emergency situations declared by the European Council.

As a last resort, ESAs also have the power to adopt decisions addressed to individual financial market participants. This power is limited to exceptional circumstances where the competent authority does not comply with the formal opinion addressed to it in relation to:

– a breach in EU law;

– an emergency situation requiring coordinated action by national authorities; and

– disagreements between competent authorities in cross-border situations.

This power is also limited to EU law which is directly applicable to financial market participants by virtue of existing or future EU Regulations.

As it stands, the Government intends that the PRA will sit on the EBA and EIOPA, and the FCA will sit on ESMA. It is anticipated that the PRA and the FCA will co-ordinate under a MoU to ensure that the UK’s interests are adequately represented at an EU level.

In practice, it would appear that the “twin peaks” model of financial regulation in the UK does not align directly with the EU supervisory model. Each ESA will have responsibility for both prudential and conduct issues for their respective market segments. In contrast, the PRA will be the micro-prudential regulator for systemic financial institutions in the UK and the FCA will be both a market-wide conduct regulator and micro-prudential regulator for less systemic institutions in the UK.

Particular concerns have been aired by insurance intermediaries, which will be regulated by the FCA for both conduct and prudential matters, but representation at an EU level will be through the PRA. In its evidence to the House of Commons Treasury Select Committee, the London and International Insurance Brokers Association cautioned that the FCA should not be a junior partner to the PRA and should play a full role in EIOPA’s work on all issues affecting intermediaries to ensure that the UK’s voice is adequately heard.

This reflects the broader concerns in the House of Commons Treasury Select Committee’s 26th Report on the FCA published on 10 January 2012 that the changes to the FSA may lead to a fragmentation of UK representation in the EU. It also cautioned that the MoU between the PRA and FCA may not be a sufficient means to ensure co-ordination at the EU level, so it recommended that the Government sets out the means of co-ordination in secondary legislation, rather than in a MoU between the PRA and the FCA in respect of their seats on the ESAs.
6.3_FCA coordination with EU and global stakeholders

As seen above, the ESAs have powers which allow them to make decisions which supersede decisions made by national authorities and even make decisions directly affecting financial institutions. The FSA has published a number of papers which contain sections which discuss how the FCA intends to coordinate with the ESAs and how it views the FCA's role in the European and global context.

**FCA's Position Paper (June 2011) and HMT's Paper (June 2011)**

The FCA's Position Paper states that the "FCA will play an active and constructive role in shaping the development of the common framework for regulation and supervision at a global level and in the EU."

The FSA had a seat on ESMA's Management Board and chairs the Secondary Markets Standing Committee. The FCA will inherit the FSA's role and will be fully involved in the development of drafting binding technical standards.

Although the FCAs' priorities in the current EU agenda is likely to be similar to that of the EU consumer protection goals, the FCA's position paper states that the FCA will also want to tailor regulation in a way that addresses specific market failures in the UK.

The amended FSMA (at new section 354A) provides that the FCA must take such steps as it considers appropriate to co-operate with other persons (whether in the United Kingdom or elsewhere) who have functions (a) similar to those of the FCA, or (b) in relation to the prevention or detection of financial crime. The persons referred to do not include the Bank of England or the PRA, and "co-operation" may include the sharing of information which the FCA is not prevented from disclosing.

**FSA's Annual Report 2011**

In its annual report, the FSA considered the ESAs to be the key policy making forums in the EU, leaving the FSA and its successors to act primarily in a policy-influencing and national supervisory role. The FSA stated that a major focus of its work was engaging with the Financial Stability Board (FSB) to develop the new prudential regulatory framework, particularly capital, liquidity and resolution.

On the issue of the ESAs' power to issue binding technical standards, the FSA took the view that the ESAs should follow a proportionate approach to rule-making and be mindful of the principle of subsidiarity, which states that "the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States." Furthermore, the FSA believed that an evidence-based approach should be followed in order to decide whether a rule is necessary. If a rule is to be drawn up, the FSA was of the view that consideration of other priorities and resources should determine when the work on developing the standard takes place.

The FSA annual report addresses the ESAs' powers of binding and non-binding mediation, the former being a new power under the ESA regulation. The FSA had a preference for non-binding mediation. However, the Omnibus Directive has amended sectoral legislation to permit binding mediation in areas specified by the sectoral legislation. This may be initiated by either party to a dispute or on the ESAs own initiative.

The FSA stated that in an emergency situation the ESAs should focus on coordination and exercise by an ESA of its emergency power should meet the requirement of EU law. The FSA provided a list of issues the ESAs should be mindful of when exercising its emergency powers. In particular, exercise of the emergency power should:
– fall within the scope of the ESAs’ powers;
– satisfy the proportionality and subsidiarity requirements;
– comply with the principles of the Meroni decision; and
– not breach the provision on fiscal safeguards.

In the FSA’s view it was therefore important that the ESAs assess whether the decision to exercise its emergency powers would be ultra vires, contrary to public law or have a disproportionate effect on the member state, competent authority or the institutions concerned. The FSA suggested that the ESAs mitigate the risk of legal challenge (see below) to a decision of exercising its emergency and temporary banning powers by utilising the legal resource that exists with national supervisory authorities. The FSA suggested that this could be done by establishing a standing panel of competent lawyers which could be asked for its views on a proposed exercise of powers.

In relation to the ESAs’ investigation powers, the FSA stated that the process should be designed to be fair, transparent, proportionate and responsive to the issues in question.

The FSA supported the consumer protection objectives given to each ESA, which include maintaining a degree of oversight of the products/services offered to consumers in each sector. The FSA suggested that the ESAs should consider the different degrees of protection required for retail customers and non-retail customers, the latter of which are better able to look after their own interests. Furthermore, the FSA was of the view that on many issues, national authorities will be closer to consumers and in a better position to understand their behaviour. Therefore, close cooperation between the ESAs and the national authorities on delivering the consumer protection objective is imperative.

FSA response to Practitioner Panel Annual Report 2011

The FSA published its response to the Practitioner Panel Annual Report 2011. The Panel comments on the work the FSA undertook in 2011. The Panel focused on the restructuring of the UK regulation and developing UK policy, future European and global initiatives. In relation to EU and global regulatory initiatives, the Panel wanted to ensure the implementation of EU and global regulatory initiatives is appropriate and proportionate for the UK market. In particular there was emphasis that, where possible, industry and the regulator should speak with a coordinated voice on strategic issues to maximise the influence of the UK.

At the European level, an increasing amount of legislation is being adopted as regulations as opposed to directives. This in turn triggers many of the direct powers ESAs have over competent authorities and financial institutions. The FSA expressed its support for the ESAs together with a strong emphasis that cooperation with the national authorities is imperative. With high profile UK representation in the ESAs, it may be considered that the UK’s interests will be strongly presented on an EU level. However, the EU’s intention of legislating through regulation is to ensure harmonisation throughout all Member States. This may be considered an ambitious challenge given that each Member State has different priorities and at any given time a Member State may wish to implement legislation/rules on a national level ahead of the European Commission agenda at EU level. Examples of this can be seen in the UK on product intervention and recovery and resolution plans (“living wills”).

As described above, the amended FSMA explicitly requires the FCA to cooperate with other persons who have the same functions as the FCA; the ESAs are highly likely to fall within this category. However, only time will identify any conflicts that may arise between the powers of the FCA and the new powers given to the ESAs.
6.4_Transition from the FSA to the FCA

As part of the transition to the FCA, the FSA has adopted a shadow operating model of the new regulatory structure, referred to as the “twin peaks” system within the FSA. In a speech to the British Banker’s Association in February 2012, Hector Sants announced that the FSA would adopt the “twin peaks” operating model from 2 April 2012, meaning that banks, building societies, insurers and major investment firms have already been subject to two groups of supervisors from that date, one focusing on prudential matters, and one focusing on conduct. All other firms that are not dual-regulated have been under the sole supervision of the conduct supervisors.

In addition, the FSA is helping the FCA and PRA create their new rulebooks, which will come into effect when the new regulators acquire their legal powers (“the legal cutover”). In October 2012, the Treasury announced its intention that the new regime be fully established and operational on 1 April 2013. The overall approach to amending the rulebook ready for legal cutover is based on only making the changes that are required properly to implement the Act and support the creation of the new regulatory structure. This approach aims to control the degree of change for the regulators, firms and others at legal cutover.

The FSA is still consulting on the proposed changes to the rules and principles, and it is of some comfort to firms that these changes will not be applied retrospectively. Firms and individuals who were previously regulated by the FSA will not need to reapply to become regulated by the FCA and the PRA as the transfer will be automatic. Firm reference numbers and individual reference numbers will remain the same and there will be only one register for all firms accessed via the FCA and PRA websites. Similarly, online reporting systems such as Gabriel and ONA will continue to be used and applications made to the FSA but not completed by legal cutover will not need to be re-submitted as the application will be transferred to the appropriate regulator automatically.

On 4 February, the FSA announced that it intends existing waivers and rule modifications to be grandfathered to either the FCA or the PRA as at 1 April. Existing waivers and modifications will move over to the new regulator that has adopted (or designated) the rule that the existing waiver or modification relates to. From 1 April, any variation of an existing waiver will be assessed against the factors set out in new section 138 of FSMA.
7_ FCA business plan and risk outlook 2013/14

These two documents are a helpful barometer to the direction the FCA will take within the first year of its existence.

The FCA reiterated its strategic priorities, namely, addressing the following risks:

**Failure to design products and/or services that accommodate consumer needs or long term interests**

The FCA will focus its efforts on challenging poor product governance practices or failure to observe products through its lifecycle. Focal point will be appropriate targeting of consumer segments and the likely of particular distribution strategies of achieving a fair outcome for consumers.

The FCA has indicated that it continues to consider replacement of guidance with rules particularly around the division of responsibilities between product providers and distributors (RPPD).

Further, attention would be given to fee structures within the asset management sector causing consumer detriment and mortgage arrears and forbearance management.

**Poor understanding by consumers of risk and return exacerbated by search for yield or income and which results in inappropriate risk taken.**

Whilst the FCA admits that it is in development mode of a strategy in this area, it is willing to dedicate significant resource into research. Interest only mortgages is an area of existing concern and the FCA will be reporting on its findings shortly following some work with industry and consumer bodies.

**Opaque distribution channels**

This theme will look into financial incentives and remuneration structures operated by firms and which are likely to yield misalignment with consumers’ interests.

The FCA has also indicated a willingness to utilise its new financial promotion banning powers to attack misleading communications. Conflict of interests in the asset management sector are high on the FCA's agenda and particularly practices that are inconsistent with fund managers' agency duties and which may contribute to erosion of returns and loss of trust.

Custody banks will also be a focal point for the FCA in particular in connection with systems and controls and the provision of secondary, ancillary services.

Of particular interests is the statement by the FCA that some practices in the wholesale markets require further examination given the relative bargaining powers of the different counterparties. These include payment for order flow, dealing commission and stock lending fees.

**Innovative, complex, or risky funding strategies posing risks to market integrity and consumer protection**

The FCA continues to be concerned with the fundamental fact that future needs of firms and consumers are shaped by past financial decisions. It stated that as economic and market conditions remain stressed, the struggle to make the best of past decisions and prepare for an uncertain future will continue.
Schedule 1

Regulatory Structure

Bank of England

**FPC**
(committee of Court of Directors of BoE)

- **PRA** (limited company, wholly owned direct subsidiary of BoE)
- **FCA** (company limited by guarantee, same legal entity as current FSA)

FPC powers of recommendation and direction to address systemic risk

Prudential Regulation
- systemic infrastructure (e.g. clearing houses)

Conduct Regulation
- dual-regulated firms (e.g. banks, building societies, investment banks)

Prudential & Conduct Regulation
- all other regulated firms (e.g. investment managers)
## Schedule 2

### Functional overview of the FCA

<table>
<thead>
<tr>
<th>Responsibility</th>
<th>Firms Regulated</th>
<th>Objective(s)</th>
<th>Corresponding European Supervisory Authorities (ESAs)/International Bodies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conduct of business regulation of all firms</td>
<td>Systemically important ‘dual regulated’ firms (conduct of business regulation only)</td>
<td>Strategic objective: protect and enhance confidence in UK financial system</td>
<td>European Securities and Markets Authority (ESMA) voting seat</td>
</tr>
<tr>
<td>Prudential regulation of firms not regulated by PRA</td>
<td>All other regulated firms (prudential &amp; conduct of business regulation): Investment managers, financial advisers</td>
<td>Operational objectives:</td>
<td>---</td>
</tr>
<tr>
<td>Market conduct regulation:</td>
<td></td>
<td>– Facilitate efficiency and choice in market for financial services</td>
<td>International Organisation of Securities Commissions (IOSCO) &amp; International Association of Insurance Supervisors (IAIS) – representation remains TBC. February 2011 consultation paper suggests that FCA as conduct regulator may hold the former FSA IOSCO seat, but notes that BoE (as regulator of central counterparty clearing houses) and PRA (in connection with regulatory capital regime around exposures to CCPs) will both have an active interest in IOSCO’s work)</td>
</tr>
<tr>
<td>– Supervising trading infrastructure (other than systemically important infrastructure – settlement systems and clearing houses – for which BoE will be responsible)</td>
<td></td>
<td>– Secure appropriate degree of protection for consumers</td>
<td></td>
</tr>
<tr>
<td>– Supervising markets for issuing of securities, including acting as UK Listing Authority</td>
<td></td>
<td>– Protect and enhance integrity of UK financial system</td>
<td></td>
</tr>
<tr>
<td>– Oversight of on-exchange and over-the-counter (OTC) markets and monitoring to prevent market abuse</td>
<td></td>
<td>“Free-standing duty” to have regard to measures to minimise extent to which regulated business can be used for purposes connected with financial crime</td>
<td></td>
</tr>
<tr>
<td>(Likely to acquire responsibility for consumer credit from Office of Fair Trading)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint responsibility with FCA for Financial Services Compensation Scheme</td>
<td></td>
<td></td>
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<tr>
<td>Operation of Financial Crime Information Network (FIN-NET)</td>
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</tbody>
</table>
## Schedule 3

**Functional overview of the FCA**

<table>
<thead>
<tr>
<th>Body</th>
<th>UK Representative(s) (voting)</th>
<th>Other interested parties may include</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU Council, including EU Financial Services Committee</td>
<td>HMT</td>
<td>PRA, FCA</td>
</tr>
<tr>
<td>European Banking Authority (EBA)</td>
<td>PRA</td>
<td>FCA, Bank</td>
</tr>
<tr>
<td>European Securities and Markets Authority (ESMA)</td>
<td>FCA</td>
<td>Bank, FRC</td>
</tr>
<tr>
<td>European Insurance and Occupational Pensions Authority (EIOPA)</td>
<td>PRA</td>
<td>tPR, FCA</td>
</tr>
<tr>
<td>European Systemic Risk Board (ESRB)</td>
<td>BoE</td>
<td>PRA, FCA</td>
</tr>
<tr>
<td>Financial Stability Board (FSB)</td>
<td>HMT, BoE, PRA/FCA</td>
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<tr>
<td>Basel Committee on Banking Supervision (BCBS)</td>
<td>BoE</td>
<td>PRA</td>
</tr>
<tr>
<td>Bank of International Settlements (BIS)</td>
<td>BoE</td>
<td></td>
</tr>
<tr>
<td>International Organisation of Securities Commissions (IOSCO)</td>
<td>FCA</td>
<td>Bank</td>
</tr>
<tr>
<td>G20 leaders’ meetings</td>
<td>Prime Minister</td>
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<tr>
<td>G20 Sherpa meetings</td>
<td>Cabinet Office</td>
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<tr>
<td>G20 Finance Ministers’ meetings</td>
<td>HMT</td>
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<tr>
<td>G20 Central Bank Governors’ meetings</td>
<td>BoE</td>
<td></td>
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<tr>
<td>International Monetary Fund (IMF)</td>
<td>HMT, BoE</td>
<td>PRA, FCA</td>
</tr>
<tr>
<td>International Association of Insurance Supervisors (IAIS)</td>
<td>PRA</td>
<td>FCA</td>
</tr>
<tr>
<td>Joint Forum</td>
<td>PRA, FCA</td>
<td>Bank</td>
</tr>
<tr>
<td>Organisation for Economic Cooperation and Development (OECD)</td>
<td>HMT</td>
<td>Bank</td>
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</tbody>
</table>
GLOBAL PRESENCE

Allen & Overy is an international legal practice with approximately 5,000 people, including some 512 partners, working in 42 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

<table>
<thead>
<tr>
<th>City</th>
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<tbody>
<tr>
<td>Abu Dhabi</td>
<td>Düsseldorf</td>
<td>Munich</td>
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<tr>
<td>Amsterdam</td>
<td>Frankfurt</td>
<td>New York</td>
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<td>Antwerp</td>
<td>Hamburg</td>
<td>Paris</td>
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<tr>
<td>Athens (representative office)</td>
<td>Hanoi</td>
<td>Perth</td>
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<tr>
<td>Bangkok</td>
<td>Ho Chi Minh City</td>
<td>Prague</td>
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<td>Beijing</td>
<td>Hong Kong</td>
<td>Riyadh (associated office)</td>
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<td>Belfast</td>
<td>Istanbul</td>
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<td>Doha</td>
<td>Milan</td>
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<tr>
<td>Dubai</td>
<td>Moscow</td>
<td>Washington, D.C.</td>
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