

A New Approach to Financial Regulation: The End of the United Kingdom FSA

On July 26, 2010, HM Treasury published a consultation paper (the “Consultation”) setting out far reaching reforms to the structure of financial regulation in the United Kingdom.¹ The Consultation follows the announcement by the Chancellor of the Exchequer² that the UK Financial Services Authority (“FSA”) would be abolished, prudential supervisory powers returned to the Bank of England, and the ‘tripartite system’³ of financial regulation brought to an end. The specific proposals include the transfer of the FSA’s functions to four new bodies: the Financial Policy Committee (“FPC”), the Prudential Regulation Authority (“PRA”), the Consumer Protection and Markets Authority (“CPMA”) and a Serious Economic Crime Agency⁴, which would take over the FSA’s role in prosecuting market abuse and insider dealing.

The UK Government will present further details and proposals, including draft legislation, for further consultation in early 2011. The reforms will then be implemented in 2012. During the transitional period, and prior to legislation, structural changes will be made at the FSA in preparation for the proposed reforms. FSA staff will be seconded to a “shadow” PRA and CPMA in the first quarter of 2011 and an interim FPC will be established in the autumn to carry out preparatory work.

I. MACRO-PRUDENTIAL REGULATION

It is proposed that the Bank of England will have overall control of macro-prudential regulation by creating within it, the FPC. The primary objective of the FPC is to improve the overall resilience of the financial system by addressing systemic risks and vulnerabilities and cyclical imbalances, unlike the PRA and CPMA, it will not have direct regulatory responsibility for any individual firms. The FPC will have the authority to identify risks and imbalances in the financial system and take decisive action to mitigate such risks. Its three main functions will be:

- **Monitoring** the financial stability of the UK’s financial system as well as the activities of the PRA and CPMA;

¹ <http://tinyurl.com/HMconsultation>

² Chancellor of the Exchequer’s speech at Mansion House, June 16, 2010

³ <http://tinyurl.com/mansionhousespeech>

⁴ The tripartite system is composed of the Bank of England, the FSA and HM Treasury, which are collectively responsible for financial stability.

⁴ It is anticipated that a further consultation will be released detailing the proposal.

- **Taking action** to address imbalances and vulnerabilities and giving directions and recommendations to the PRA and CPMA on the regulatory tools that should be deployed in pursuit of macro-prudential policy; and
- **Reporting** to the public and the Parliament through regular financial stability reports.

The Government will provide the FPC with a number of “macro-prudential tools” to enable it to perform its role. Many of the suggested tools involve the use of micro-prudential levers, such as capital requirements and leverage limits. Therefore, the PRA, in its role as micro-prudential regulator, will be required to implement the FPC’s decisions on the use of its macro-prudential tools and apply them across all relevant firms.

II. PRUDENTIAL REGULATION

The primary objective of the PRA will be to promote the stable and prudent operation of the financial system through the effective regulation of financial firms. By separating the functions of prudential and conduct of business regulation, the Government argues that the PRA will facilitate a more “judgement-led style of prudential regulation” with greater discretion to investigate and understand individual institutions’ business models and strategies.

A. SCOPE

The PRA will be responsible for the authorization, regulation and day-to-day supervision of all firms who are subject to significant prudential regulation, including banks and deposit takers, broker-dealers and insurers. The FPC may recommend a further expansion of the scope of the authority of the PRA.

Secondary legislation will be introduced to outline which “regulated activities” will be regulated by each of the authorities. The PRA’s responsibilities will include the regulation of deposit-taking, effecting and carrying out contracts of insurance, and dealing in investments as principal. The PRA and CPMA will each be responsible for granting or amending permissions to carry out the regulated activities that fall within their remit. Each of the PRA and CPMA will also be responsible for approving persons to undertake “significant influence” functions in authorized firms. The two authorities will be expected to work closely in making their respective decisions.

B. POWERS AND FUNCTIONS

The Government will consult on draft legislation to provide the necessary powers to both the PRA and CPMA. One option is to employ FSMA as the template for the legal framework governing the PRA. If that model is followed, the various powers and functions established under the FSMA will be divided into separate standalone, prudential and conduct of business frameworks. Certain of these powers and functions will be transferred exclusively to either the PRA or CPMA; in other cases, powers and functions may overlap.

The key functions of the PRA will include: making the rules which govern regulated activities by financial firms; authorizing firms to engage in regulated activities; approving individuals to perform controlled functions; and supervising and exercising judgments on the soundness of financial firms.

The PRA will also be responsible for making rules about and approving firms' "recovery and resolution plans" ("RRP") which will specify the actions to be taken by management in order to restore a firm to health. The Government is also considering giving further powers to the PRA to enable it to require specific management actions to be taken in the event that a firm fails to deliver the actions detailed in its RRP, or if those actions prove insufficient. An example of such enforced management action could include the requirement to issue new equity.

III. CONSUMER PROTECTION AND MARKET AUTHORITY

The Government believes that ordinary consumers in retail markets have not enjoyed an appropriate level of regulatory protection, because the FSA has been responsible for both prudential and conduct business regulation. It is argued that the FSA has focused on the prudential health of regulated firms and that as a consequence, consumers and markets have suffered. Accordingly, the new CPMA will be established as the single integrated conduct regulator with a primary objective of protecting customers and ensuring market integrity.

A. SCOPE

The CPMA will be responsible for the conduct-of-business regulation of all financial institutions, including those authorized by the PRA in their dealings with ordinary retail customers. The CPMA will be solely responsible for the authorization and supervision of all financial institutions not regulated prudentially by the PRA. It will also create and enforce retail conduct of business and market conduct rules and regulate conduct in wholesale financial markets.

B. POWERS AND FUNCTIONS

The CPMA's powers and functions will broadly follow the model set out in FSMA, with modifications to enable the CPMA to carry out its conduct-focused responsibilities in a more effective manner. The CPMA will be responsible for: creating and enforcing retail conduct of business and market conduct rules where firms and corporate clients of financial services firms participate in wholesale financial markets; granting permissions for all regulated activities which are classified as 'non-prudential'; approving individuals to perform conduct related controlled functions within financial firms that are also prudentially regulated by the PRA; and approving all controlled functions where firms are solely regulated by The CPMA . The CPMA will also be responsible for supervising and enforcing its conduct rules.

C. MARKET CONDUCT DIVISION

Within the CPMA, there will be established an operationally distinct market conduct division, focused on the regulation of conduct in wholesale financial markets and the provision of market infrastructure. It will also represent the UK in the new European Securities and Markets Authority (“ESMA”).

In this role, the CPMA will be responsible for regulating the conduct of participants in: organized financial markets whose facilities are provided by investment exchanges and MTFs; OTC financial markets in which off-exchange dealings take place between financial institutions and other wholesale market participants; and dealings in all financial instruments and other derivative contracts traded on those markets.

With regard to the regulation of market infrastructure, the new CPMA will be given the responsibility for regulating exchanges and other trading platform providers, central counterparty clearing houses and settlement systems. The Consultation is seeking guidance on whether the FSA’s role, as the United Kingdom Listing Authority (“UKLA”), in regulating primary market activities, such as offering securities and admitting securities to listing, should be merged with the Financial Reporting Council as a first step towards creating a companies regulator under the Department for Business, Innovation and Skills, or whether the functions of the UKLA should be transferred to the CPMA.

IV. COORDINATION AND COOPERATION

In order to fulfill its role in identifying and assessing risks to the financial system, there will need to be close cooperation between the FPC and the two regulators. The Government proposes to ensure coordination by appointing the chief executives of the PRA and CPMA to the FPC. The Government also intends to legislate to create formal processes for information sharing to ensure effective communication between the three bodies.

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For additional information, please feel free to contact any of your regular contacts at the firm if you have any questions.

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