Reform of the UK Financial Services and Markets Act 2000

On November 19, 2009, the Financial Services Bill (the "Bill")[1] was presented to the UK Parliament and had its second reading before Parliament on November 30, 2009. The Bill, when enacted, will significantly enhance financial regulation in the UK by making a number of amendments to the Financial Services and Markets Act 2000 ("FSMA"), which will augment the powers of the Financial Services Authority (the **"**FSA**"**). FSMA constitutes the legislative framework that governs the UK financial services industry.

Although the primary focus of the Bill is the regulation of systemically important banks, certain provisions of the legislation will also impact upon the operations of other market participants such as hedge funds, particularly in relation to disclosure and short selling.

The principal areas covered by the Bill are as follows: (i) the establishment of a Council for Financial Stability; (ii) the expansion of FSA disciplinary powers; (iii) restrictions on short selling; (iv) controls on executive remuneration; (v) collective action; and (vi) certain other consumer protection measures.

1. BACKGROUND

The structure of the UK's regulatory system was established by a program of regulatory reforms in the Labour government's first term of office, which included the enactment of the Bank of England Act in 1998 and FSMA in 2000. These reforms divided responsibility for financial regulation between the so called Tripartite Authorities: the Bank of England, Her Majesty's Treasury ("HM Treasury") and the FSA. Although the regulatory system has been amended periodically during the course of the last decade, the majority of those changes have been required as part of the implementation of the legislative reforms which constitute the European Union Financial Services Action Plan.

The UK's initial response to the financial crisis was focused on putting in place emergency measures. The Banking (Special Provisions) Act 2008 ("BSPA") was passed in February 2008, in order to permit the government to take the collapsed bank Northern Rock into public ownership, and perform a number of other interventions against failing lenders.

[1] Available at: http://www.publications.parliament.uk/pa/cm200910/cmbills/006/10006.i-ii.html

The BSPA was replaced by the Banking Act 2009 in February 2009, which introduced a Special Resolution Regime ("SRR") that allows failing or collapsed banks to be transferred into public ownership or into the hands of other market participants under exigent circumstances.

By mid-2009, the government's attention had shifted to long-term reform of the UK and global financial sectors. In February 2009, the government commissioned an independent review of corporate governance in the UK banking industry (the "Walker Review")[2]. In July 2009, a consultation paper relating to this review was published in tandem with a consultation paper setting out the government's proposed scheme for reforming the financial system. The Bill reflects the outcome of these consultations, as well as the recommendations agreed at G-20 summits in London and Pittsburgh during 2009. On November 26, 2009, HM Treasury published the final version of the Walker Report.

While many of the government's emergency response bills were enacted rapidly with broad cross-party support, the decrease in the perception of urgency means that the Bill faces a much higher level of scrutiny and accordingly, a slower passage through Parliament. The legislative process began with the Bill's "first reading" in the House of Commons on November 19. It is further complicated by the upcoming UK general election, which must take place no later than June 3, 2010. While the government hopes that the Bill will be enacted before the election, this outcome is far from certain. The Conservative Party, the main party of opposition to the government, has outlined a radically different proposal. The Conservatives have proposed to abolish the FSA and the current tripartite structure. They intend that the Bank of England will have responsibility for the health of the overall financial system, and plan to create a new Consumer Protection Agency, which will safeguard the interests of retail consumers.

2. COUNCIL FOR FINANCIAL STABILITY

The Bill establishes a new Council for Financial Stability (the "Council") composed of the Chancellor of the Exchequer, the Chair of the FSA and the Governor of the Bank of England. The Council will have overarching responsibility for safeguarding the financial stability of the UK.

The Council will meet at least quarterly to review the stability of the UK's financial system and coordinate the action taken by the three represented authorities to protect and enhance stability. HM Treasury is empowered to publish "terms of reference" for the Council setting out its objectives and working practices in more detail. Such terms of reference must be prepared or reviewed in consultation with the FSA and the Bank of England, and must be laid before Parliament. HM Treasury has published in draft the terms of reference that it intends to promulgate under the Bill. It contemplates that in the current

[2] Available at: http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

financial climate the Council will meet at least once a month, and also provides for a monthly supporting meeting of deputies of the represented authorities.

The Council's functions are currently undertaken by a Tripartite Standing Committee in which the same three institutions are represented, established pursuant to a memorandum of understanding on March 22, 2006. It is intended that the Council will perform the same functions in a more transparent and accountable fashion.

3. EXPANDED REGULATORY POWER

The Bill amends FSMA so as to give the FSA specific authority to intervene in relation to certain short-selling and remuneration practices, and to require firms to produce Recovery and Resolution Plans ("RRPs").

The Bill extends the scope of the FSA's general rule-making and permission-varying powers, allowing them to be exercised in pursuit of any of the FSA's regulatory objectives. The Bill also allows the FSA to intervene against firms entering the UK market from other states in the European Economic Area (the "EEA") for the same purpose. Furthermore, the "protection and enhancement of the stability of the UK financial system" is established as a new regulatory objective. The FSA is therefore empowered to regulate to protect financial stability.

The Bill also extends the FSA's information-gathering power. This power may be exercised against any person who manages or has an interest in a "relevant investment fund"[3] that holds securities traded in the UK or issued by an UK-incorporated body, any person who provides services or a facility to an authorised person, and any other person whom HM Treasury may designate as long as the power is exercised for the purpose of obtaining information that is or might be "relevant to the stability of one or more aspects of the UK financial system". Furthermore, the FSA is empowered to seek information on behalf of regulators in other countries in respect of funds holding securities traded in, or issued by, corporations established in such third countries. Firms that are not authorised persons may therefore be forced to divulge information to the FSA if this is considered appropriate to safeguard the financial stability of the UK or other countries.

Finally, the Bill significantly increases the range and severity of sanctions that the FSA may impose. The following provisions expand the scope of the FSA's enforcement power:

- the FSA is empowered to fine any individual carrying out a "controlled function" (certain financial services and activities) without FSA approval;

[3] The Bill gives guidance as to what may constitute a "relevant investment fund": "arrangements may constitute an investment fund even if there is only one person participating in the arrangements".

- the range of sanctions that can be applied to individuals “approved” by the FSA that are guilty of misconduct is extended to include suspension or limitation of such authorization to carry on certain “controlled functions” for a period of up to two years;

- an FSA authorized firm that contravenes any requirement under FSMA or a directly applicable EC regulation made under the Markets in Financial Instruments Directive may be sanctioned by having its permission suspended, limited or restricted for up to twelve months;

- provisions of FSMA that prohibited the FSA from punishing a single contravention with both a fine and withdrawal of authorization are repealed, giving the FSA more flexibility in combining disciplinary powers;

- the limitation period applicable to FSA disciplinary action is doubled from two to four years; and

- the circumstances in which the FSA may require authorized firms to conduct a review of past business in the context of establishing consumer redress schemes are extended (see “Other Consumer Protections” below”).

4. RESTRICTIONS ON SHORT SELLING

The FSA previously introduced a ban on the short selling of financial stocks on September 19, 2008. The ban was introduced through the Code of Market Conduct, by deeming certain behaviour to constitute, in the FSA’s view, “market abuse”. The FSA took the position that because of the financial climate at the time, and in particular the ongoing capital raisings at several high profile financial institutions being undermined by short selling, that a short-term prohibition of short selling certain financial stocks would promote orderly markets. The ban ended on January 16, 2009. In addition to the ban, on June 20, 2008, the FSA also introduced a disclosure regime for short selling stock of companies that are undertaking rights issues. This disclosure regime remains in force.

The Bill provides that the FSA may prohibit short selling of specific financial instruments or types of financial instruments, or may require disclosure to be made in respect of such short selling. These rules may apply to short selling by any person, whether authorized or not, who is in the UK, even temporarily, and who either deals through a UK intermediary or who engages in short selling of shares listed on regulated markets in the EEA. This power may be exercised, even if the shares are dual-listed and the short selling in question takes place on a non-EEA market. Disclosure requirements may apply to all open short selling positions, even in respect of short selling activity undertaken before the requirements were put in place. Where the FSA considers that it is necessary to maintain confidence in, or to protect the stability of, the UK financial system, it may make short selling rules without complying with the normal requirement for the FSA to consult in relation to new rules. Rules passed in such an emergency will lapse after three months, unless the FSA exercises its power to extend their application by a further six months.

The FSA is also empowered to require information, including from non-authorised persons, in order to determine whether they, or persons connected with them, have contravened short selling rules. Parties found to have done so, or who refuse to provide information, are subject to public censure or an unlimited fine.

5. EXECUTIVE REMUNERATION

The Bill provides a framework for the disclosure of executive remuneration and the imposition of restrictions on remuneration in line with the recommendations of the Walker Review and the reforms agreed at the G20 summit held in Pittsburgh in September 2009.

HM Treasury is empowered to require, by regulation, that some or all authorised persons produce and disclose an "Executives Remuneration Report" similar in scope to the "Directors Remuneration Report" produced by quoted companies. HM Treasury may require that this report sets out the remuneration of all "relevant executives" of the authorised person, and "anything connected with" such remuneration. "Relevant executives" may be defined by the regulation, and may encompass any officers, employees or other persons having a "prescribed connection" with the authorised person.

The FSA is required to make rules providing that some or all authorised persons must put in place remuneration policies. Such policies must be consistent with the "effective management of risks," and must give effect to the Implementation Standards for Principles of Sound Compensation Practices issued by the Financial Stability Board (the "FSB") on September 25, 2009 (the "Implementation Standards")[4]. Furthermore, in making rules on remuneration the FSA is required to have regard to "international standards" generally.

The FSA is empowered to require the revision of remuneration agreements that are not in compliance with its rules. In other words, the FSA may terminate remuneration agreements that have already been entered into to the extent that they do not comply with the Implementation Standards. HM Treasury is empowered to direct the FSA to investigate whether a specific remuneration plan complies with the FSA's rules.

In addition to the provisions that apply only to "significant financial institutions", the Implementation Standards include a number of specific proposals on corporate pay structure, including the following:

- remuneration of employees in risk and compliance functions should be independent of business performance, and be adequate to attract qualified and experienced staff;

[4] Available at: http://www.financialstabilityboard.org/publications/r_090925c.pdf

- subdued or negative financial performance should generally lead to a considerable contraction on variable compensation;

- for senior executives and other employees whose actions have a material impact on risk exposure, a substantial portion of compensation should be variable, and at least 40-60% of that portion should be deferred for at least three years;

- a substantial portion (i.e. at least half) of variable compensation should be paid in shares or share-linked instruments;

- guaranteed bonuses should be paid only exceptionally, and then only to newly hired employees in respect of the first year of employment; and

- termination provisions in employment contracts should be related to performance and "designed in a way that does not reward failure," and existing termination provisions should be re-evaluated for alignment with long-term value creation and prudent risk-taking.

The Walker Review focuses on the remuneration policies of banks and other financial institutions (referred to as "BOFIs") and includes certain more detailed recommendations to be considered by the FSA when implementing the Bill, including as follows:

- remuneration committees should scrutinise the pay of all individuals in a BOFI who perform "significant influence functions" for the entity or whose activities have, or could have, "a material impact on the risk profile of the entity" ("High End Employees");

- remuneration committee reports should disclose in bands the number of High End Employees, including executive board members, and within each band, the main elements of salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution; and

- High End Employees and executive board members in a BOFI should have their remuneration spread over five years, with half of their variable remuneration in the form of a long-term incentive scheme with vesting subject to a performance condition – half should vest after not less than three years and the remainder after five years – and short-term bonuses should be paid over three years, with not more than a third in the first year.

6. RECOVERY AND RESOLUTION PLANS

The Bill requires the FSA to make rules requiring some or all authorised persons to prepare a "recovery plan" and a "resolution plan", often referred to in the media as a "living will". A recovery plan must set out how the authorised person's business is to be continued by the authorised person or another person in the event of circumstances adversely affecting the carrying on of its business. A resolution plan sets out the action to be taken in the event of likely or actual failure of the business or part thereof. The FSA's rules must require that such plans be put in place for all banks, building societies and credit unions. With respect to other authorised persons, the FSA is given flexibility to determine who should be covered by the new rules. It is contemplated in the explanatory notes to the Bill that this will allow for gradual implementation whereby the rules will initially apply only to large, complex and systemically important firms, but will ultimately be required from other authorised persons.

The specific requirements of the recovery and resolution plans are left to the FSA to determine, but it is contemplated that such plans may involve the maintenance of an "emergency data room" that can be brought into use quickly in the event that a forced sale of the business is required. In making these rules, the FSA is also required to have regard to "international standards," which will include the internationally agreed standards for recovery and resolution plans being prepared by the FSB.

It is contemplated that authorised persons may require information from third parties in order to comply with their obligations to produce RRPs. Where a request for information that is made for this purpose is authorized in advance by the FSA, any duty of confidentiality owed by the third party in respect of the information requested, whether under a contract or otherwise, is waived for the purposes of the answer.

7. COLLECTIVE ACTION

The Bill introduces the possibility of class actions for "financial services claims", by allowing a court to approve a representative to bring proceedings on behalf of persons who are themselves entitled to take proceedings in respect of the financial services claim set out in the court order. A person may be authorized by the court to act as representative even if the person would not otherwise be regarded as having an interest, or any sufficient interest, in the proceedings.

A "financial services claim" means under the Bill any cause of action that (a) is against a person who (at the time it arises) is an authorized person (including payment service providers and appointed representatives), and (b) relates to a regulated activity (including ancillary services and a payment service).

In addition, the Bill includes provision for claims to be on an "opt-in" basis, whereby each claimant must specify to the representative that their claim be included in the class action, or an "opt-out" basis, whereby all claims are included unless a UK claimant has opted out.

8. OTHER CONSUMER PROTECTIONS

The Bill contains certain other consumer protection provisions:

- a power enabling the FSA to require firms to set up a consumer redress scheme where the FSA has found evidence of widespread or regular failures of the industry to comply with regulatory standards and where consumers have suffered as a result;
- the Bill amends the Consumer Protection Act to ban unsolicited credit card cheques, making it a criminal offence to provide credit card cheques otherwise than following a specific request.

*   *   *

For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under banking and finance in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at:

http://www.cgsh.com/financial_crisis_resource_center/eu_resources

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax