HM Treasury and the Financial Services Authority Provide Further Details of the New Financial Regulatory System for the United Kingdom

On 16 June 2011, HM Treasury published ‘A new approach to financial regulation: the blueprint for reform’, setting out the Government’s proposals for reforming the current system of financial services regulation in the United Kingdom. Comments are invited on a range of high-level questions (including on the objectives and scope of the new regulators, their governance and accountability) by 8 September 2011.

The document extends to more than 400 pages, the bulk of which is taken up by a draft bill amending the existing Financial Services and Markets Act 2000 (“FSMA”) to give effect to the proposals. The Government considered, but rejected, introducing an entirely new act, on the grounds that amending the existing legislation would be less disruptive to regulated firms.

The main outlines of the new structure had already been announced prior to June 2011:

- The establishment of the Financial Policy Committee (“FPC”), a single body with responsibility for protecting the financial system as a whole, including identifying and monitoring systemic risks and exercising intervention powers to ensure appropriate action is taken to ensure stability. The FPC will be a committee of the Court of the Bank of England.
- A subsidiary of the Bank of England, the Prudential Regulation Authority (“PRA”), will become the prudential regulator of firms that manage significant balance sheet risk as a core part of their business. These firms will include banks and insurance companies, along with the larger investment firms. The precise scope of PRA supervision will not be defined on the face of the revised FSMA; instead, the PRA will be given the power to determine what are to be treated as “PRA-regulated activities” and thus to determine which firms will fall within its remit.
- A third regulator, the Financial Conduct Authority (“FCA”), will be responsible for conduct of business regulation, covering retail, wholesale and market conduct. It will also be the prudential regulator of those firms not systemically important enough to be prudentially regulated by the PRA (the vast majority of firms, around 24,500 out of a total of approximately 29,000). As a matter of legal form the FCA is likely to be the Financial Services Authority (“FSA”) under a new name (in the same way as the FSA was the new name for the previous lead regulator, the Securities and Investments Board).

Given that a significant minority of firms will be ‘dual regulated’ by both the PRA and FCA, co-operation and co-ordination between the two regulators will be crucial to the success of the new regulatory system. Rather than prescribing the means by which effective co-ordination between the two should be achieved, the Government has left it to the PRA and FCA themselves to devise appropriate arrangements. This avoids the inflexibility that legislative prescription would impose, which has clear advantages when it comes to developing and improving arrangements between the PRA and FCA. That said, there remains the possibility that over time, as the cultures of the two organisations develop, the desire to “defend turf” will become more prevalent at the expense of co-operation (something of the sort occurred in the multi-regulator model under the Financial Services Act 1986, which preceded the FSMA), and it will be interesting to see what steps the PRA and FCA can take to counteract this.

At the end of June the FSA published a paper complementing the earlier Treasury document, setting out how the FCA would approach the delivery of its objectives. This paper is set out at a high level outlining the FSA's initial thinking, although that thinking will be refined in the period before end-2012 (the date by which the necessary legislation is planned to be passed, although not necessarily in force). Comments on the FSA document are requested by 1 September.

For firms that are regulated by the FCA alone (which will include most investment managers), the proposed alteration to the regulatory structure will not, as such, result in any great change. Instead of dealing with a single regulator, the FSA, they will from day - to - day be dealing with a single regulator, the FCA. And as these firms will not be systemically important, the creation of the FPC and the FPC's relationship with the PRA and FCA is unlikely to have any impact upon them.

Nonetheless, there are features of the proposed regime that will be capable of making a difference to the way in which FCA-regulated firms carry on business. For example:

- the FCA intends to intervene earlier in retail markets to protect consumers than the FSA has done, building on the more aggressive and intrusive approach the FSA has taken following the credit crunch;
- as part of the above, the FCA will have the power to intervene to prevent the sale of products where consumer detriment is occurring; and
- perhaps most controversially, the FCA will have the power (as will the PRA) to publish the fact that a warning notice has been given to a firm - that is, to publicise the fact that a firm is the subject of disciplinary action even if the firm is ultimately successful in challenging the regulator. This risks significant reputational damage to a firm where no grounds for such damage exist, and though the FCA is expected to consider this aspect when deciding whether to exercise the power, it is hard to see how this risk could be eliminated. The Treasury line would appear to be that the desirability of transparency in the enforcement action taken by regulators, and the impetus that this will give to an improvement in the way in which firms treat their customers, outweighs any unjustified damage there might be to a firm's reputation in an individual case - which is clearly a debatable proposition. In this context, it might make sense for the FCA to publish a general statement as to the circumstances where it is likely to exercise this power, and the factors that it will take into consideration when taking such a decision.

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