

Financial Services and Markets

Treasury White Paper: Reforming Financial Markets

The government issued its White Paper on reforming the financial markets on 8 July 2009. For such a long document the new and concrete proposals are surprisingly few and far between. However, the White Paper does not sit in isolation and action has already been taken or is under way to address some of the perceived issues. Much of the paper is therefore dedicated to summarising the various initiatives that are already in progress, both domestically and internationally (e.g. the special resolution regime in the Banking Act 2009, the reform of banking remuneration practices, regulatory capital changes, a new liquidity regime etc).

This note largely focuses on the specific legislative proposals made in outline in the White Paper in respect of which consultation questions have been raised. It remains to be seen how many of these proposals make their way to the statute book. **Consultation responses are requested by 30 September 2009.**

The Tripartite System

The so-called tripartite regulatory system, which has been subject to considerable public criticism over the last few months for failing to forestall the worst of the financial crisis, will remain in place – at least for the remainder of this government. (The Conservative Party has clearly signalled that it would scrap it if elected and hand prudential supervision of banks, building societies and "other significant financial institutions" to the Bank of England.)

In the autumn, the relatively informal and *ad hoc* Standing Committee of the Treasury, the Bank and the FSA will be replaced by a more formal, statutory **Council for Financial Stability**, chaired by the Chancellor of the Exchequer, with explicit terms of reference and published minutes. The objectives of the Council will be to analyse and examine risks to the financial stability of the UK's economy and to coordinate an appropriate response, together with an additional role to discuss and coordinate a position on EU and international financial stability and regulatory policy issues.

With what might be seen in some quarters as a questionable prioritisation of the issues threatening financial stability, the first meeting of the Council will consider the issue of remuneration, with the FSA presenting its new Code, together with an annual report on remuneration practices and the risks they pose.

Financial stability: an additional FSA statutory objective

The FSA's statutory "mission statement" is set out in Sections 3 to 6 of the Financial Services and Markets Act 2000 ("FSMA") by way of four regulatory objectives: the preservation of market confidence, the raising of public awareness, the protection of consumers and the reduction of financial crime. The Government proposes to add a fifth objective, that of financial stability, to complement the financial stability objective already given to the Bank of England under the Banking Act 2009. Under this objective the FSA will be required to take into account, in the context of its *existing* functions, the impact not only of domestic issues, but also the impact of international developments on financial stability within the UK.

To complement other initiatives and the new financial stability objective, forthcoming legislation will amend the FSA's existing principles of good regulation as set out in Section 2(3) of FSMA to provide that the regulator must take into account any possible wider economic and fiscal costs when deciding which regulatory action to take against a firm.

Even more power for the FSA

One might be forgiven for thinking that the FSA already has a huge range of powers and certainly enough to tackle the identified causes of the financial crisis. In fact, the Government goes so far as to say that the financial crisis was not caused by a lack of powers within the UK's regulatory regime. However, the Government still proposes further enhancement of the FSA's statutory powers in the following ways:

- it will amend the FSA's general rule-making power under section 138 FSMA to allow the regulator to make rules, not only where it appears "necessary" or "expedient" to do so for the purposes of protecting the interests of consumers, as now, but also where to do so is in line with its regulatory objectives (as expanded – i.e. including the financial stability objective);

- similarly, it will amend the existing power of the FSA under section 45 FSMA to vary a firm's permission on the Authority's own initiative so that it can be exercised in furtherance of any of its regulatory objectives (as expanded);
- the FSA's power to intervene against incoming EEA firms under section 194 FSMA will also be enhanced with a similar reference to the regulatory objectives;

In addition, the FSA's enforcement powers will be beefed up in the following ways:

- over and above the existing powers to issue fines against firms and individuals and to vary a firm's permission, the FSA will also be given a power to suspend individuals or firms for misconduct;
- the FSA will be given a power to impose penalties on individuals who perform a controlled function without having FSA approval.

The White Paper does not set out any details as to how, precisely, these powers would be exercisable or their interrelationship with the existing powers in the regulatory toolkit. For instance, it is unclear as to how the power to suspend an individual or firm "for misconduct" would apply – would this be an interim measure available to the FSA pending finalisation of an investigation for suspected misconduct?

The Government will also be looking into whether the FSA should be granted any additional or extended information-gathering powers over and above the ones it already has (the Banking Act 2009 has already extended the FSA's information-gathering powers to allow it to collect information that is relevant to the stability of individual firms and/or the financial system). The focus will be particularly upon whether the regulator's powers over persons outside the regulatory perimeter need to be extended.

The sun never sets?

Those elements of the UK's market abuse regime which are superequivalent to the provisions of the EU Market Abuse Directive ("MAD") (i.e. sections 118(4) and 118(8) FSMA) were, on implementation of MAD, made subject to a "sunset clause" whereby they would be removed by 30 June 2008, unless extended. Following a consultation the sunset clauses were extended until 31 December 2009 in expectation that the EU review of the MAD regime would be complete by then and the domestic regime would then be aligned with that of Europe. However, because the EU review has been subject to delay and the FSA used the "superequivalent" provision in section 118(8) as the basis upon which to introduce its emergency short-selling restrictions last year, the Government has decided that it will extend the sunset clauses until 31 December 2011.

In addition, the Government also proposes to amend FSMA to provide that the FSA's powers to take emergency action to implement restrictions on short selling and to require disclosure of short positions are independent of its powers under the market abuse regime (which makes the argument for extension of the sunset clause less compelling). At the same time, the FSA will be given the power to make rules implementing a permanent disclosure regime in relation to short positions in UK stocks. Subject to the detail, this is to be broadly welcomed.

Systemically significant institutions

While a point for discussion, rather than a concrete legislative proposal, the White Paper dedicates a chapter to "systemically significant institutions". In the paper systemically significant institutions are described as being "typically, but not necessarily, regulated firms such as banks". However, unregulated off-balance sheet vehicles may also be systemically significant. The Government says that the regulatory system will need to adapt to provide for "flexibility in the regulatory perimeter".

As regards deposit-takers, the Government's January 2009 consultation paper '*Financial stability and depositor protection – strengthening the framework*' proposed that banks must develop their own internal contingency plans to "minimise the disruption arising from their own failure". This might mean establishing clear lines between deposit-taking activities and other banking operations carried on by the firm.

More widely, the Government will work with the FSA and Bank of England and with international partners to develop a framework for identifying what constitutes a systemically significant institution, and what requirements should apply to them, including but not limited to higher capital requirements. The findings of this work will be published later this year and specific conclusions on the implementation of the framework will follow.

Hedge funds

These days, it seems, any discussion by a government or a regulator on the financial crisis would not be complete without a mention of hedge funds. The Government supports the findings of the Turner review that UK hedge fund managers should be subject to enhanced disclosure requirements and is working with the FSA in this regard and to ensure that the regime is backed by a credible enforcement framework. In passing, the Government takes the opportunity to express its misgivings with the proposed EU directive on Alternative Investment Fund Managers, describing it as requiring "significant improvement".

Compensation

The recent banking crisis highlighted the fact that the Financial Services Compensation Scheme was inadequately funded to meet the costs of large scale failures in the deposit-taking sector. The Government's tentative proposal is that there should be a pre-funded element within the FSCS to cover the deposit-taking sector. However, the Government is reluctant to introduce this idea too soon, while the banking system is still recovering from the shocks of the financial crisis – therefore, subject to a consultation process, pre-funding will not be introduced before 2012.

The Government is also considering amending FSMA to include an explicit power to enable it to require the FSCS to act as the single contact point in the UK for deposit-guarantee schemes in other Member States, to act as the UK agent for non-UK compensation schemes and to act as paying agent in other cases where arrangements have been made to make payments to UK customers of firms.

Consumers: Money Guidance and Consumer Education and Information Authority

The Government will introduce primary legislation shortly with a view to launching a national money guidance service ("Money Guidance") from Spring 2010. All relevant financial services firms will be required to contribute to the costs of Money Guidance. This will include consumer credit firms solely licensed by the OFT and which are not subject to the FSA levy.

Legislation will require that the FSA establishes an independent consumer education and information authority. The FSA will be granted levy-raising powers to collect revenues from FSA-regulated and OFT-licensed firms.

Consumers: redress

The Government proposes that the FSA should be given power to require firms to conduct a "review of past business failures" investigation to determine the extent of their liability to consumers. (Currently the Treasury has the power to initiate collective redress schemes under section 404 FSMA.)

This new power would encompass not only FSA rule breaches but other areas where the FSA has supervisory responsibility, including payment services. The Government even suggests that the power might extend to breaches of contract law. While such a scheme would apply on an opt-in/opt-out basis, this is a potentially significant proposal and (subject to the outcome of the White Paper consultation) one would need to see the detail of the draft amending legislation to assess the precise implications.

On a similar note, the Government also floats the idea of giving the FSA the power to appoint a nominated representative body or person to pursue a representative "class" action through the courts where the FSA believes that there is evidence of a breach of its rules (and possibly in other circumstances). Again, there are potentially significant implications behind this proposal.

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley, Mark Evans, Tim Lewis or Nigel Barratt in the Financial Services and Markets Department or your usual contact at Travers Smith.

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