

Joint Committee call for evidence on the draft Financial Services Bill Submission by the Investment Management Association

Executive Summary

- It is logical in principle to separate prudential and conduct regulation as the objectives of the two are different and can be in conflict. IMA members expect to be regulated on both by the FCA.
- While it is right that the regulators should be completely independent in exercising their supervisory responsibilities there is a need for a clear mechanism for holding them to account over the way in which they do so.
- The sweeping power accorded to the PRA to veto decisions by the FCA has the effect of prioritising stability over consumer protection. Although this may be appropriate on occasion, the power should be more limited in scope and made more transparent. For example, we believe that it should be for the Treasury, and not the PRA itself, to determine whether or not the basis for a decision to veto an FCA decision should be published.
- The scope of the Bill needs to be clarified - while we expect all asset management firms to be regulated by the FCA this requires confirmation.
- The FCA's objectives are broadly correct but its remit does need to be extended to include competitiveness so as not to put the UK at a disadvantage to other jurisdictions, for example when it comes to domiciling/re-domiciling funds.
- The current Financial Services Compensation Scheme needs radical re-design. The enabling powers in the Bill need to reflect this.
- There should be an independent complaints commissioner - appointed by the Treasury - to deal with all complaints about the PRA and FCA.
- The Bill also provides an opportunity for more radical reform and this has perhaps not been fully taken advantage of. For example, the "permissions" regime and Regulated Activities Order are not only out of date but are not in line with EU legislation which is what drives the operating environment for financial services firms today.

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1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

In one sense there is no such clear division in the proposed regime. The majority of firms will still have FCA as the sole regulator. The division is more generally one of separating out those firms whose balance sheet design is such that they need monitoring against distinct objectives because of the level of their potential exposure to disorderly failure and participation in systemic instability. That distinction both underlies the proposed scope and causes the existing uncertainty as to where some firms will end up. In answering this and other questions, it would have been helpful to have seen a draft of the proposed scope order (clause 6 and new section 3G). We are expecting all asset management firms to be supervised by the FCA, but would welcome confirmation; and we think that insurance subsidiaries of asset management firms, which exist only to provide wrappers for pooled investments, do not need to be regulated by the PRA.

That said, there is clear logic in separating prudential and conduct regulation. The objectives of the two are completely different and can be in conflict. It is in the nature of prudential regulation that it pays scant attention to mis-selling and investor protection. Indeed until 2009 the FSA did not fully regulate retail conduct of business by banks, although it did do so for other distribution channels – direct sales, IFAs, wealth managers, and so on. This reflects a historic lack of engagement by banking regulators with consumer protection issues.

We therefore welcome the proposal for the same regulator to address conduct issues across the board. We return to the question of potential conflict of interest in response to question 4 below.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

We do not think there are many relevant comparators internationally, given the size and complexity of the UK financial sector. The nearest equivalent is the US, where regulation is far more fragmented than in the UK.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We do not question the structure the draftsman has chosen. But as a practical matter it does make it difficult and confusing in navigating one's way around such a complex piece of legislation. More generally, it is important that the approach of the new regulators be unconstrained by the past even as it is informed by it.

There is one area however where a completely fresh start needs to be made. The current structure of permissions and the Regulated Activities Order is no longer fit for purpose. It stems from legislation which predates the establishment of the FSA and fails to reflect the EU-based rules under which financial firms nowadays operate.

The result is that firms are required to obtain multiple permissions in order to carry out what is in fact a single activity (for example, managing a collective investment scheme). The result is not simply cost and confusion for regulated firms, but also greater difficulty in

tailoring rules to different sectors. For example, when the Treasury introduced the bank payroll tax, it sought to define target institutions on the basis of FSA permissions, which meant that a large number of other firms would have been brought within its net without an elaborate exercise to ensure that not covered by the policy were in fact excluded. The Regulated Activities Order is in need of a fundamental overhaul.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We believe steps need to be taken to improve the accountability of the regulators for the way in which they discharge their responsibilities. It is of course right and proper that the regulators should be completely independent in the exercise of their judgment; there should be no room for Government or Parliament in the process of supervision and enforcement.

But the regulators need to be held to account for how well they have met their statutory duties. For example, in the last three years defaults by FSA-regulated investment intermediaries (including, but not exclusively, Keydata Investment Services) have led to some £460 million of compensation under the Financial Services Compensation Scheme. These have entailed significant costs for other firms who for the most part had no connection with the activities giving rise to the compensation claims. While it is accepted that there should not be a "zero failure" regime, and that where compensation is due it is properly for the industry, not the taxpayer, to fund, it is reasonable to ask:

- Whether the losses by investors, and the consequent compensation bills, could have been reduced by earlier regulatory intervention; and
- What lessons the regulator should learn for the future.

While it is welcome that there will be a duty on the each regulator to investigate itself, there appears however to be no mechanism by which these questions can be subjected to independent scrutiny, short of the "nuclear" option of an independent Treasury-initiated review under section 14 of FSMA. (That power does not extend to the regulation of clearing houses now that is moved to the Bank of England and it is unclear why there should be such an omission.)

We are of the view there should be a single independently appointed **complaints commissioner** able to determine all FCA and PRA complaints; this would prevent co-ordination complaints falling between two stools. The appointment and removal should be by the Treasury.

We would like to see a more public role for the **non-executive directors** of the regulators. This could in part occur at the Annual Public Meeting but also we would like to see fuller discussions of the FCA Board's reasoning for supporting or opposing specific rule changes. Dissenting comments should be recorded. Commonly we find the publication by the SEC of supporting and dissenting positions on regulatory issues very helpful; the publication of voting by members of the Monetary Policy Committee provides another precedent.

We note as regards **annual reports** the PRA must carry out a public consultation but have no annual public meeting, whilst FCA must have such a meeting but are not required to consult. We are not convinced that there is a good policy reason for such differences.

Finally the new powers place an even greater burden on the FCA to ensure that its internal processes are of the highest standards. A number of changes were introduced by the FSA in the wake of the enforcement process review following criticisms made by the Financial Services and Markets Tribunal (as it was) in the Legal & General case, including the separation of supervision and enforcement from the **Regulatory Decisions Committee**. But the speed at which the FCA may be expected to act in relation to some of its new powers demands a much more explicit statement of the processes and protections be put in place (or preserved in the transition from the FSA).

We have a particular concern about the power in section 3H for the **PRA to veto proposed actions by the FCA**. As noted above, the interests of a prudential and a conduct regulator respectively may sometimes be in conflict. Section 3H in effect provides that in such an event financial stability considerations shall always override consumer detriment. We welcome the provision in section 3J for the details to be laid before Parliament, which would allow public debate of the case. But section 3J (7) gives the PRA sole right to determine that publication would be against the public interest. We believe this places far too much power in the PRA's hands, and that non-publication should be subject to a much more rigorous test.

Section 3H would seem to apply even in cases where the FCA is the competent authority for the purpose of consolidated supervision – for example in the case of an insurance company owned by an asset management firm. We see no reason why the PRA should have an override power in such cases.

Nor is it acceptable that PRA might veto a decision by FCA to prosecute.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

We do not have any specific comments about the objectives of the FPC as set out in section 9C. Any actions to dampen shocks or manage credit bubbles would be welcome.

We welcome new section 9E(2), the duty to seek to avoid prejudicing the advancing by the FCA and PRA of their objectives. New section 9E(3)(c) is also welcome, the need to have regard to the international obligations of the UK; this is a concept we would like to see advanced to the FCA (and PRA).

- 6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?***
- 7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?***
- 8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?***
- 9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?***

We would suggest that there should be clarity as to what tools FPC would have in practice. Presently, the very existence of the FPC and the market intelligence gathering needed to support it, is likely to provide benefits to the regulatory system compared to the recent past even if there are few tools at its disposal.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

The wide remit of the FPC and the objectives of the PRA should be sufficient to deal with any perceived risks. The actions that might need to be taken would likely have to be globally co-ordinated by their very nature. If it were felt UK components of the shadow banking system were insufficiently or inappropriately regulated then the scope of PRA-regulated activities could be altered by order.

11. Are the PRA's objectives clear and appropriate?

We question whether the PRA's objectives are too focussed upon the UK. We would expect a provision such as at new section 9E(3)(c) for the FPC to be replicated in new section 2B.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Yes. Our concern of course extends to the quality of supervision and competence of those who might judge, but this is a issue of management style and culture ultimately. Our real fear is that FCA will approach issues "through a single lens" as may have occurred in the past with, for example, the Treating Customers Fairly initiative. TCF is a proper standard and a useful tool but it cannot be the sole lens through which other supervisory judgements are made.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

Firms should be allowed to fail, however just because some firms fail, it should not be concluded that the regime is flawed. But on the contrary when a firm does fail it should not be seen as a confirmation that the regime has operated successfully. Firm failure is not evidence of regime failure but neither should it ever be a badge of success. Therefore the prudential requirements placed upon all firms must seek to ensure that they could absorb significant losses before failure and the consequent cost that falls on the same industry through the FSCS.

In terms of crisis management, the original separation of powers between FSA and the Bank of England under section 7 of the Banking Act 2009 is arguably diminished by the PRA and the Bank of England now needing to consult one another and for the PRA to agree that the threshold conditions are no longer met. Given the policy behind section 7 was to use FSA as a safeguard, the Government should review the impact of this function being transferred to a subsidiary of the Bank of England.

We also think that the provisions on recovery and resolution plans and other crisis management issues have not sufficiently considered the role of the FCA as the body principally responsible for client asset protection policy. Orderly failure will demand thought is given beforehand to client assets (as the FSA is currently proposing) and that area is the preserve of FCA.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We agree that this will be a real challenge for both regulators. These questions are however fundamentally for management to address, not legislation.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We agree broadly with the three objectives as currently stated. However we believe they need to be augmented by requiring it to ensure that the UK does not suffer competitive disadvantage relative to other countries (a different point from the promotion of competition where we are broadly happy with the Government's proposal). Examples of this are quite common in the funds world. For example, the FSA's rules are in some respects more stringent than those of other EU jurisdictions such as Dublin and Luxembourg, whose funds may nevertheless be distributed in the UK with an EU passport. Thus the FSA rules have the perverse effect that funds which would otherwise be based in the UK (and within the FSA's jurisdiction) are instead based in Luxembourg, with no benefit in terms of investor protection. An explicit competitiveness remit would help to counter such absurd situations.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

Yes. The Government's White Paper Cm 8083 refers at several points (for example paragraph 1.40) to users of financial markets, such as institutional investors, being "consumers". While we welcome the implicit acknowledgement that investors (the "buy side" of the market) are in a very different position from the "sell side" it is important that this should not translate into any suggestion that comparable levels of investor protection regulation are appropriate. Wholesale investors are in a completely different position from retail ones, and this needs to continue to be recognised.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We support proposals for a step change in consumer protection; we were the first body to call for an increase in the levels of deposit protection during the crisis and we supported the introduction of the consumer redress scheme powers.

Nevertheless the new section 137C (product intervention) is almost unlimited in its width. While we understand that there is a need to consider product intervention on a much more proactive basis, the proposed clauses give unprecedented power to the FCA. We think there is still a need for greater thought about how it might operate especially in relation to authorised persons providing cross border services and with contracts formed under the laws of other countries. Alongside a legitimate concern to ensure that consumers do not suffer detriment, there is a need to provide some level of legal certainty so as not to deter all product innovation in the UK.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We think this is satisfactory; the real issue lies with ensuring prudential debates in Europe are informed from an investment firm perspective and not merely that of banks. We should record however that our interaction with CEBS over the remuneration principles was entirely positive.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

It is to be hoped that bringing all retail conduct of business regulation together in a dedicated regulator will mean the application of uniform standards to all distribution channels. Up to now most of the focus of regulation, for example the Retail Distribution Review, has been on independent financial advice, but there have been several instances in recent years of mis-selling in non-advised sales environments. The new arrangements may, if effective, offer the prospect of improved standards.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

Where rules derive from EU directives impacting firms in FCA and PRA, such as the capital requirements directive, there will be a need to preserve a consistent and coherent approach. But in practice we expect this will be more relevant to the exercise of supervisory judgments than an issue for the rules themselves.

Otherwise, the number of FSA rules impacting investment managers which are wholly domestic in origin is not large. This will become even more apparent as the European Supervisory Authorities address harmonisation across the Single Market.

We think it vital that the desire of the FCA to have better market intelligence does not lead to duplication by it (or the PRA) of work conducted at the Bank of England. We consider that the market intelligence unit of the Bank of England is likely to be the central place for a large part of the market intelligence that needs to be gathered. It should share that intelligence with the regulators.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

There is not a perfect match between the PRA/FCA and the new European regulatory authorities, which are sectoral rather than functional in nature. For the reasons given in response to questions 1 and 19 above, we believe that the proposed UK structure has significant advantages over the EU one.

But it will present significant challenges for the new UK regulators, since there will be only one seat on the Board of each: for the PRA in the case of the European Banking Authority and European Insurance and Occupational Pensions Authority, and FCA in the case of the European Securities and Market Authority. It will require the PRA to liaise closely with the

FCA on conduct issues within EBA and EIOPA; equally FCA will have to ensure it seeks input from the Bank of England on markets and exchanges.

We consider that this inconvenience is significantly outweighed by the benefits of having a single integrated conduct regulator.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

We have concerns about the proposals for the **financial services compensation scheme** (Clause 33 of the draft Bill). This provides broadly similar powers to make a scheme as in FSMA, but split between the FCA and PRA. It is unclear how this responsibility will be divided between the two, or how differences of view will be resolved. Our understanding is that it is the intention that the two regulators would respectively make rules for different parts of the scheme. We are unconvinced that the high level co-operation duties will be sufficient to ensure a joined-up set of rules.

We fear that regulators making different rules about different parts of the scheme could result in a *de facto* separation into two schemes, one for PRA firms and one for FCA firms. In that event it could be that investment managers became liable for all mis-selling compensation under FCA jurisdiction, including those of products of PRA firms like banks and life insurers, and not just those in respect of investment products. This would be unacceptable.

The FSA have said that they plan to review the operation and funding of the present scheme. Our experience of the Keydata case (see response to question 4 above) has led us to the conclusion that in its present form it contains significant flaws, particularly as regards the arrangement for cross-subsidy between different levy-paying classes, and we have opened a dialogue with the FSA about this.

Our principal point is that if one group of firms is to be asked to cross-subsidise a default giving rise to compensation, there needs to be a reasonable degree of affinity between that group and the firm where the default took place. Otherwise the liability for cross-subsidy should extend across all firms covered by the scheme.

Many investment managers are manufacturers of an approved product – a UK authorised fund. We believe they should ring-fenced from any liability resulting from actions of firms which intermediate securities. At present there appears to be better regulatory treatment in terms of FSCS risks for a firm that manufactures a fund in continental Europe and passports it in to the UK than vice versa.

The historic problem with the FSCS sub-classes partly arises because most classes are organised on a manufacturer/distributor basis – insurance and mortgages are such examples. The issue with investments is that most manufacturers are issuers (PLCs and SPVs) and so not within the FSCS ambit. As a result the existing rules require fund manufacturers to be the sole subsidising body for distributors of a range of products unconnected with funds.

We believe this is fundamentally wrong and is detrimental to the UK as a fund management centre. To avoid this we believe that the powers in Clause 33 should be limited so as to require that rules should meet the following criteria:

- No firm shall be required to cross-subsidise a failure in another unless there is affinity between the products and services concerned
- Where no such affinity exists, and cross-subsidy is necessary, a levy shall be applied to all firms covered by PRA or FCA.

The role of the FSCS is such that its governance and powers should be reviewed. The size and nature of its role in compensation and resolution suggest that it should be seen as a stand-alone entity whose rules are made or approved by the Treasury, not by the regulators. We also consider that:

- FSCS should have its own rule-making powers to facilitate its activities, for example in relation to single customer views and other preparedness issues.
- Based on our experience of the Keydata debacle, we consider that, alongside investors being compensated, the FSCS should have power to review firms who might contribute to the ultimate funding of the losses, or to require FCA so to act.
- While the FSCS will commonly pay out investors upon a default, it should be within its powers (perhaps exceptionally) to “wait and see”. This might involve a declaration that a person has suffered detriment but that payment of some or all of the compensation can await what happens to a product. Thus if they bought a 5 year bond and expected no payout until year 5, it may be appropriate to wait until the maturity date before paying compensation, since the underlying investment may have recovered to the point where it can pay out, notwithstanding that an intermediary has defaulted.

All these points stem from our belief that the FSCS should be seen as a mature body in the regulatory system and not merely as a mechanical implementer of rules made at a time when (as will always occur) some events were just not foreseen.

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