WHITE & CASE

# **Insight:** Capital Markets

March 2013

# The UK's New Financial Services Act – a Guide to the Main Changes

The UK's Financial Services Act 2012 (the **Act**) will come into force on 1 April 2013. On implementation, the Act will amend many of the UK's existing financial services legislative measures and give effect to several of the Government's financial regulatory reform proposals.


**Stuart Willey**
**Partner and Head of the London Regulatory practice**
+ 44 20 7532 1508
swilley@whitecase.com

**Carmen Reynolds**
**Of Counsel, London**
+ 44 20 7532 1421
creynolds@whitecase.com

White & Case LLP
5 Old Broad Street
London EC2N 1DW
Tel: + 44 20 7532 1000
Fax: + 44 20 7532 1001


The Act will:

- **Change the framework for financial regulation and supervision in the UK**, giving significantly enhanced powers to the Bank of England and legislative underpinning for the UK's new, "twin-peaks" approach to regulation. Two new regulators will take over the Financial Services Authority's (**FSA**) current functions.
- **Create new powers of intervention for the regulators**, allowing them to ban, or impose restrictions on, the sale of financial products and issuance of financial promotions. Regulators will also be granted powers of direction over parent companies of certain UK financial institutions.
- **Bring the setting and administration of the London Interbank Offered Rate (LIBOR) within the scope of UK regulation**, making the submission of LIBOR a regulated activity and creating a new offence of manipulating a specified financial benchmark.
- **Enable the transfer of Consumer Credit regulation from the Office of Fair Trading to the new Financial Conduct Authority (FCA)**. The transfer is to take place on 1 April 2014.
- **Introduce a consumer "super-complaints" mechanism**, allowing certain consumer bodies to complain about market features in the UK which may be significantly damaging the interests of consumers.

As part of the new regulatory regime, the new financial supervisors will move towards a much more judgment-led approach to supervision and away from the previous, and narrower, more rules-based approach.

The Act will make amendments to the Bank of England Act 1998, the Financial Services and Markets Act 2000 (**FSMA**) and the Banking Act 2009, amongst other measures. In addition to these changes, draft legislation is in the pipeline in other areas. For example, the Banking Reform Bill is currently going through the UK parliamentary process and, when enacted, it is intended to provide for the mandatory ring-fencing of retail banking operations, enhanced provision for loss absorbing bank capital and the creation of a new regime for retail depositor preference in the event of a bank's insolvency. Some of these measures are also subject to legislative proposals at European level which may impact on the final legislative text and the timing of its implementation in the UK.

The remainder of this note looks at some of the key changes being introduced by, and practical implications of, the Act for UK regulated entities and their parent companies.

## (i) New UK framework for financial regulation and supervision

The Act places the Bank of England at the heart of the new regulatory framework and creates a form of "twin-peaks" regulatory regime with separate prudential and conduct regulators supervising individual financial institutions.

The new regulatory framework will be as follows:

**Financial Policy Committee of the Bank of England**
Responsible for macro-prudential policy or the soundness of the UK financial system

**Prudential Regulation Authority**
A subsidiary of the Bank of England, responsible for the prudential regulation of individual banks, insurers and systemically important investment firms

**Financial Conduct Authority**
The re-named FSA. Responsible for markets (including listing and supervision); conduct of business; prudential supervision of smaller investment firms and fund managers

### Financial Policy Committee

The Bank of England's Financial Policy Committee (**FPC**) will be responsible for macro-prudential regulation and is tasked with contributing towards the Bank of England's new financial stability objective.

More specifically, the FPC's role will include identifying, monitoring and taking action to remove systemic risks with a view to protecting and enhancing the resilience of the UK financial system. Its remit includes focusing on levels of leverage, debt or credit growth in the UK financial system, the distribution of risk within the financial sector and the interconnectedness of financial institutions.

The FPC may make recommendations, or direct the financial supervisors to exercise their powers in a way which ensures the implementation of the macro-prudential measures identified by the FPC. Such directions or recommendations may be given in relation to authorised persons generally or to a class of them, but may not relate to a specified financial institution.

### Prudential Regulation Authority

A new subsidiary of the Bank of England, the Prudential Regulation Authority (**PRA**), will be responsible for the prudential supervision and stability of individual banks, insurers and systemically significant investment firms.

The PRA's objective is to promote the safety and soundness of PRA regulated firms. It is required to advance this objective primarily by seeking to minimise any adverse effects of the failure of a PRA authorised firm on the UK financial system and to ensure that firms carry on their business in a way that avoids adverse effects on the system. In the case of insurers, the PRA has an additional objective of contributing to securing an appropriate degree of protection for policyholders.

### Financial Conduct Authority

The FSA will be the conduct regulator and is to be renamed the Financial Conduct Authority. It will have joint oversight of firms regulated by the PRA, with the PRA supervising such firms from a prudential perspective, and the FCA exercising responsibility in relation to conduct matters for those firms.

The FCA will be the sole prudential regulator for smaller investment firms and fund managers.

Its role under the new legislation is to:

- regulate standards of conduct in retail and wholesale markets;
- supervise trading infrastructures that support those markets;
- exercise prudential supervision over firms that are not PRA-regulated; and
- conduct the functions of the UK Listing Authority (**UKLA**).

The FCA has the single strategic objective of ensuring that the markets for financial services function well. Three operational objectives support this, namely: (i) securing an appropriate degree of protection for consumers (including professional and potentially wholesale consumers); (ii) protecting and enhancing the integrity of the UK financial system; and (iii) promoting effective competition in the interests of consumers in the markets for financial services.

## (ii) Overlap between the PRA and FCA

The new system introduces an inevitable degree of supervisory duplication for those firms and groups which will be regulated by both the PRA and FCA. The regulators have given considerable thought and consulted fairly extensively on how to deal with potential areas of overlap between their areas of responsibility but nevertheless, the emerging picture has the potential for inefficiency and confusion in practice.

A memorandum of understanding between the PRA and FCA will cover co-ordination between the two regulators, including in relation to matters such as exchange of relevant information. Click here to view a draft of the memorandum of understanding.

## (iii) What is happening to firm authorisations and the approval of individuals performing controlled functions?

### Who will be PRA authorised?

The FPC is to be responsible for monitoring the perimeter of financial regulation by deciding what is within, or without, the scope of regulation. The Committee has the power to make recommendations to the Treasury about changes to the scope of regulation by the PRA or FCA. Accordingly, in order to ensure sufficient flexibility, the Treasury may specify by order which activities are to be PRA regulated activities and which are to be FCA regulated activities.

Under the new arrangements, deposit-taking, effecting and carrying on contracts of insurance and certain activities in relation to the Lloyd's insurance market are to be prudentially regulated by the PRA as of 1 April 2013.

In addition, the PRA will be given power to designate certain investment firms for prudential regulation by it. It may do this where the scale or complexity of such a firm's operations and its interconnectedness with other firms or the system as a whole give rise to a risk to the stability of the financial system or the safety and soundness of one or more PRA-authorised persons within their group. The PRA will only designate investment firms where:

- they have permission to deal in investments as principal;
- they are required to have initial capital of at least Euro 730,000 under the Capital Adequacy Directive; and
- designation is desirable, having regard to the PRA's objectives.

In addition, the PRA must also have regard to:

- the assets of the firm; and
- if the firm is a member of a group, the assets of other firms in the group and the interconnectedness of those firms.

The PRA has made it clear that the decision to designate will involve the exercise of judgment and will not follow automatically from the application of the designation criteria.

The PRA will consult the FCA before designating an investment firm for prudential regulation by the PRA, or before revoking a designation.

### New authorisations and applications to grant, vary or cancel regulatory permission

The relevant prudential regulator will lead and manage a single administrative process for authorising firms. For dual-regulated firms, the PRA will lead the process. It will, however, seek the consent of the FCA to the authorisation or in relation to the granting of a new permission to an already dual-regulated firm. It will also consult the FCA in relation to the removal or cancellation of a dual-regulated firm's permission.

Similarly, the FCA will consult the PRA before authorising, varying or cancelling the permission of an FCA regulated firm that is part of a group containing a dual-regulated firm.

Each regulator should assess the application for authorisation and a firm's on-going fitness and properness for authorisation against the relevant Threshold Conditions for authorisation. Under the Act, fairly extensive changes have been made to the previous threshold conditions for authorised persons. The new Threshold Conditions are to be found in The Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013 and differ according to the type of firm seeking authorisation. Dual-regulated firms will be subject to both PRA and FCA Threshold Conditions.

### Approval of Individuals

Both the PRA and the FCA will be responsible for maintaining an approved persons regime for the firms they regulate.

Generally, for dual-regulated firms, lead responsibility for approving individuals to perform 'Significant Influence Functions' will be split between the PRA and the FCA depending on which regulator acts as "designator" of that function. The regulator designating that function will manage a single administrative process, communicating all formal notices and decisions to the firm and/or individual as appropriate. The FCA and the PRA will each consult the other before designating "Significant Influence Functions".

The PRA will designate those functions deemed to be materially connected to the prudential soundness of a firm. Such functions include the CEO and Chairman functions. The PRA will lead the approval process for all such functions and will require the consent of the FCA (where it has an interest in the function) before taking its decision.

The FCA will lead on all functions related to a firm's interface with customers including client assets, anti-money laundering and compliance. For such roles, the FCA will be solely responsible for the process including communicating all formal notices and decisions to the individual.

Moreover, the non-executive director function will be jointly regulated by the FCA and the PRA.

## (iv) Supervision of firms subject to dual regulation

Firms subject to the PRA's prudential supervision and regulation will also be subject to conduct regulation by the FCA and to rules governing the issuance, listing, and trading of listed securities. In some groups, there will be entities subject to prudential supervision by the PRA and others subject to prudential supervision by the FCA, with the PRA as consolidated supervisor.

The regulators have indicated that they will routinely share information on dual-regulated firms and firms within dual-regulated groups. Supervisory colleges for individual firms and groups will be established with a view to identifying which risks and mitigating actions might have a material effect on the ability of the other regulator to advance its objectives. The frequency of the meetings of such colleges will reflect the importance of the firm to the other regulator's objectives, e.g. ordinarily six-monthly for major firms and annually for medium-sized firms. For small firms, discussions between the FCA and the PRA will be undertaken on an annual basis at sectoral level.

In normal circumstances, the regulators have indicated that they will not conduct supervisory activity jointly, because to do so would lead to confusion about each regulator's objectives, focus and culture. It is anticipated that the regulators' respective risk-profiles for a firm will reflect their very different statutory objectives. However, conclusions and key information from supervisory activity that is materially relevant to the other regulator's objective(s) will be exchanged.

The FSA's risk assessment regime, ARROW, will be replaced in the PRA by a new Supervisory Assessment Framework. This will be a continuous assessment model, focusing on judgments about key risks to the PRA's objectives. Both the individual capital guidance and individual liquidity guidance issued by the FSA to PRA-regulated firms will continue to apply. A separate risk mitigation programme will be applied for conduct.

### (v) Formal regulatory processes, investigations and enforcement

In respect of firms and groups containing firms regulated by both the FCA and the PRA, each regulator will consult with the other in advance of, amongst other things:

- Deciding to revoke or vary any permission of a firm;
- Exercising its power to impose requirements on a firm;
- Withdrawing an approval of an approved person;
- Appointing investigators;
- Issuing Warning and Decision Notices;
- Applying to commence insolvency or administration proceedings;
- Triggering resolution under the 2009 Banking Act;
- Waiving any rules that may be materially relevant to the other regulator's objectives;
- Transfers of business under Part VII of the Financial Services and Markets Act; and
- Changes of control.

The PRA has the right to veto certain FCA regulatory action(s) if it considers that the action(s) could threaten financial stability or result in the failure of the firm, with adverse consequences for the UK financial system.

The FCA will be responsible for taking actions for breach of the regulatory perimeter (that is, conducting regulated activities without authorisation).

### (vi) Change of Control

The relevant prudential regulator of the target firm will be responsible for assessing and processing applications to acquire or increase control in a firm. It will consult the other regulator in the case of dual-regulated firms and groups.

Where there are multiple change in control applications relating to the same group, the FCA will have regard to any decision of the PRA in relation to a change in control of a dual-regulated firm before deciding whether or not to approve the change in control of any FCA-regulated firms in the group.

The relevant prudential regulator should be notified when control is decreased. It will pass on such information to the other regulator as appropriate.

### (vii) UK Listing Authority

In relation to listings, the UKLA function will be maintained in the FCA. However, firms prudentially regulated by the PRA will have an obligation to notify the PRA about the submission of draft prospectuses and other disclosures to the UKLA.

Where the PRA or the UKLA function in the FCA considers that information which either has gathered would be of material interest to the other, the regulators have indicated that they will actively offer such information to the other. The PRA may ask the UKLA about the details and status of a proposed disclosure and the UKLA may ask the PRA to comment on specific aspects of draft prospectuses or other disclosure documents that depend materially on the financial soundness of the relevant regulated firm or its parent or affiliates. The UKLA will inform the PRA of any material, relevant information it holds about the financial condition of regulated firms, fundraising activities for such firms and significant transactions.

In addition, the FCA will consult the PRA in relation to decisions to delist the securities of a dual-regulated firm or a related firm and of any intention to modify or give exemptions to UKLA rules in respect of dual-regulated firms.

### (viii) Passporting

Both the PRA and the FCA will have a role in the administration of the passport notification process under the new regime.

For inward passporting applications[1] under the Banking Consolidation and Insurance Directives, the PRA is the lead regulator. The FCA may make representations in relation to such applications. For inward passporting under any other directives, the position is reversed, with the FCA acting as lead regulator, and the PRA having the right to make representations in certain limited circumstances only.

For firms established in the UK which wish to exercise passport rights in other EEA jurisdictions (so-called "outward passporting"), the PRA is the lead regulator for dual-regulated firms, with the FCA having the right to make representations. For outward passporting of firms solely authorised by the FCA, the FCA is the lead regulator, although the PRA may make representations where an applicant firm's group includes a PRA authorised person.

The lead regulator will be responsible for managing the process, providing the other regulator with copies of the application form, information and accompanying documents received and administering notices to the Home or Host State regulator and to the firm concerned.

1 That is, for applications from firms established in an EEA member state outside the UK which wish either to establish a branch in the UK or to provide cross-border services into the UK.

### (ix) Fees

The FCA will collect fees from regulated firms both for itself and also on behalf of the PRA.

### (x) Register of authorised persons and approved individuals

The FCA will be responsible for maintaining a single register covering all FCA and PRA authorised firms and approved individuals.

### (xi) Transition

#### Impact on FSA guidance

The PRA has issued a statement on how existing FSA guidance will be treated in relation to PRA authorised firms.

The following 'individual guidance' will be automatically transitioned on 1 April 2013:

- Individual capital requirements guidance, including capital planning buffers for banks and capital guidance issued to insurers;
- Individual liquidity guidance;
- Individual guidance given by the FSA that enables a firm to move from a higher proportionality tier to a lower proportionality tier as provided for in the FSA's 'General Guidance on The Remuneration Code'; and
- Guidance on the completion and submission of regulatory returns.

For other types of guidance, firms may submit a list of those items of individual guidance which they wish the PRA to review before October 2013. Firms will be able to continue to rely on guidance referred for review until the PRA reaches a decision on whether the guidance remains appropriate or otherwise. Reviews should be completed no later than October 2014.

Any guidance that is not referred to the PRA for review will cease to have any status as formal PRA individual guidance from 30 September 2013 although, if firms are satisfied that such guidance remains valid in substance under the new rules and regime, they may choose to continue to follow it.

#### Impact on pre-existing waivers and rule modifications

Following 1 April 2013, the FCA and PRA (as appropriate) will take into consideration revised criteria (set out in a new section of FSMA) (the **revised criteria**) when assessing the merits of (i) a new waiver or rule modification request, or (ii) a request to vary a pre-existing waiver or rule modification.

The FSA has confirmed that existing waivers and rule modifications granted to authorised persons will be grandfathered to either the FCA or the PRA, as appropriate, on 1 April 2013. However, the new regulators will retain discretion to prevent the grandfathering of waivers or rule modifications where (i) the requirement in question no longer remains, (ii) the underlying rules relating to the waiver have changed, or (ii) circumstances arise under which the new regulator considers that a 'grandfathered' waiver or rule modification no longer satisfies the revised criteria. It is unclear whether this discretion will be widely used.

The FSA has also confirmed that, as at 1 April 2013, any waiver or modification application that has been submitted to the FSA and remains under consideration will be passed to the new regulator that has adopted (or designated) the rule to which the application relates. The relevant regulator will then assess the application against the revised criteria. This may require firms to submit additional information going forward.

### (xii) New Powers of Intervention

#### Product and Financial Promotion Intervention

Potentially far-reaching new powers are granted to the FCA in the context of product and financial promotion bans.

**Product Intervention Rules**

The FCA is given new powers which will (i) allow it to prevent authorised firms from entering into specified agreements, and (ii) enable it to impose related requirements on firms where the FCA considers it necessary to do so in order to advance its consumer protection or competition objectives. The consumer protection objective can extend to the protection of professional, as well as retail, consumers and thus, the new power has far-reaching potential.

**Financial Promotions**

The FCA is given a new power to direct specified authorised persons to withdraw, or refrain from approving, certain financial promotions. It may also require that the recipient of the direction takes such other steps in relation to the direction as shall be specified.

#### Directions over Parent Undertakings

Significant new powers are introduced, allowing the regulators to direct certain parent undertakings of UK incorporated and authorised firms where the subsdiary is either a PRA authorised person or an investment firm.

Parent undertakings will be subject to these provisions if they meet certain conditions, namely if they are:

- UK incorporated or have a place of business in the UK;
- a financial institution of a kind prescribed by Treasury order; and
- not themselves a UK authorised person, investment exchange or clearing house.

The power may be used where the relevant regulator considers it to be desirable in order to advance any of the PRA's objectives or the FCA's operational objectives or where the issuance of a direction is considered desirable in the interests of effective consolidated supervision of the group. Directions may be given with immediate effect and may require the parent undertaking to take specified action or to refrain from taking such action. They may be imposed by reference to the parent's group or to members of its group and may relate to the past conduct of the parent undertaking. The regulators have the power to require the provision of information by parent undertakings.

The regulators have discussed the use of their new powers and it is clear that they are potentially very extensive. For example, the powers may be used where:

- one or more directors of the parent company appear not to be fit and proper, or suitable;
- there is inadequate oversight of the development of a new product by the group board of directors;
- intra-group transactions and allocation of risks and financial resources (including large exposures, booking practices, other channels of contagion and arrangements for the mitigation of risk such as by reinsurance) do not meet the standards expected by the regulator;
- the actions of the parent undertaking in a stressed situation may increase the chance of disorderly failure of the regulated entity;
- there is insufficient transferability of a group's own funds or liquid assets to support the group's regulated activities; or
- risks generated in an unauthorised part of the group could affect the stability of the authorised firms.

Examples of types of direction which may be made include:

- A requirement for the holding company to intervene and prevent the regulated firm from selling inappropriate products;
- A requirement that the board of the holding company undertake to not pay any senior management bonuses until such time as the level of redress from crystallised conduct risks are confirmed in the regulated entity;
- A restriction on dividend payments, or other payments in respect of capital instruments, in order to retain capital in the group;
- A requirement to move funds or assets around the group to more appropriately address the risks;
- A requirement for the group to be restructured to remove any material impediments to effective supervision; or
- A requirement to include relevant regulated and unregulated entities (including shadow banking entities, where appropriate) in consolidated calculations.

Given that the regulators' new powers have the potential to affect the financial recourse, and possibly even the private legal rights, of third parties against a parent undertaking or other group company (for example, in the situation where a parent is forced to support its UK regulated subsidiary), the use of the power in a crisis situation may well prove to be controversial. In exercising it, regulators will need to act reasonably and, whilst a parent undertaking will have rights of appeal to the Tribunal should it wish to challenge a potential direction (assuming there is sufficient time for it to do this in the particular circumstances), the Tribunal does not have the power to substitute its own decision for the Authorities.

It remains to be seen whether, as a result of the proposed changes, parent undertakings will seek to locate their operations offshore and whether the regulators would accept this kind of regulatory structuring in the context of new authorisations or group reorganisations, for example.

### (xiii) What should firms do now?

Many of the changes will take place at an operational level within the new regulators and will not impact significantly on firms' day-to-day business.

However, the following action points should be considered:

- Both regulators will issue new rule books on 1 April 2013, and firms should familiarise themselves with the new regime and the regulators' approach to the supervision of such rules.

  In particular, firms should review existing internal and compliance arrangements and documentation against the new regulatory handbooks and make any appropriate changes.
- Risk assessment and mitigation programmes should be reviewed against the regulators' new statutory objectives and threshold conditions. Firms' on-going compliance with the regulatory requirements will need to be looked at on a more holistic basis whilst bearing in mind the new rules, threshold conditions and situations in which the regulators have indicated they may use their powers of direction.
- Firms should consider more mechanical issues such as amending their existing status disclosure to customers in order to reflect the fact that they are regulated by the FCA and/or PRA, as appropriate. It is currently intended that firms will benefit from a six-month transitional period in which to update their status disclosure.
- Guidance on which firms rely should be reviewed and, if it is not to be automatically transitioned, firms should consider submitting such guidance for review by the PRA before October 2013.
- Firms that benefit from existing waivers or rule modifications will benefit from the grandfathering of such waivers and rule modifications following 1 April 2013. As a result, firms will generally not be required to take any action to ensure their continuation following the FSA's abolition. However, the new regulators retain discretion to prevent the grandfathering of a waiver or rule modification where they are satisfied that it does not satisfy, *inter alia*, the revised criteria. Firms should therefore consider their existing waivers or rule modifications in light of the revised criteria.
- Firms will need to make sure that there is appropriate liaison with, and notification to, the FCA and PRA (as appropriate) in relation to specific matters going forward, where necessary.