CFA UK is a member society of

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear sir/madam,

The CFA Society of the UK (CFA UK) welcomes the opportunity to comment on HM Treasury's updated consultation on a new approach to financial regulation.

The CFA Society of the UK represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to professional standards and market practices. The committee's response is brief and addresses only some of the questions posed. However, we make a number of observations that we believe to be important and that we hope will be useful in directing HM Treasury's further work on regulation.

<u>Summary</u>

- The proposed measures are broadly sensible and an appropriate response to the recent financial crisis. The measures should help to reduce the risk of future systemic financial crises. That is to be welcomed.

- We also welcome the changed approach to the FCA so that there is a clearer intent to focus on the protection of market integrity (to the benefit of consumers).

- However, we are concerned that the new approach to financial regulation is too closely concentrated on 'fighting the last war' by focusing on systemic financial risk (the focal point for the FPC and PRA) and fails to make use of an opportunity to address regulatory weakness elsewhere.

- CFA UK recognises the benefits of a risked-based approach, however the FCA will need to ensure that the population of firms it determines to be prudentially significant must be both meaningful and effective. As we noted in our November response[1] to the original paper, across both the PRA and the FCA, there remains too little emphasis on supervision and enforcement. Regulatory measures will be ineffective without effective supervision and enforcement, just as they were prior to the financial crisis.

[1]CFA UK response to " A new approach to financial regulation: judgement, focus and stability," (Nov 2010) can be found at https://secure.cfauk.org/assets/2028/HM_Treasury_response_final_version.pdf

Insufficient focus on supervision and enforcement

There is much to welcome in HM Treasury's proposed approach. The introduction of a clear regulatory framework within which responsibility for the analysis and regulation of different elements of risk is assigned is a positive development. The governance structures and communication processes have been carefully considered and appear broadly appropriate. Accountability, too, has been improved.

However, we worry that too much confidence is being placed on the capacity for new regulation to effect change. Regulation counts for little in the absence of effective use of that regulatory framework through supervision and enforcement.

The frequency with which certain key words appear within HM Treasury's document give an indication of the scale of the problem. Regulation occurs 252 times; supervision 71 times. Regulators are mentioned 589 times; supervisors just 65 times. Enforcement is mentioned in only 38 instances.

As we wrote in November 'The experience of the financial crisis is likely to mean that regulators are aware of the need for more effective supervision for some time, but poor management will always occur, the sense that the system is working well will not take long to be re-established and, as the memory of the financial crisis fades, regulators' ability to draw sufficient funding will likely weaken.'

We accept that the regulatory framework required restructuring and that careful consideration needed to be given to the consequent governance and communication processes. However, there now needs to be a similar concentration of effort on the supervisory and enforcement practices that will support the new regulatory framework.

As is noted in 4.45 and 4.47, the FCA will have responsibility for the conduct of business regulation of all financial institutions – approximately 27,000 firms – and will be the prudential regulator for the 18,500 firms that will not fall within the scope of the PRA.

Box 4.E on p 69 makes it clear that the FCA will pursue proactive and intensive prudential supervision for a very small population of 'prudentially significant' firms. This approach will almost certainly fail and may cause the FCA to miss its operational objectives.

The approach will fail because the FCA will make a judgment at a single point in time as to which 100, say, of the 18,500 firms it should engage with; the others being allowed to report along established guidelines. However well FCA makes its selection, it will miss a number of potentially significant firms. Further, because it will not have good insight into the remaining 18,400 as they develop, the FCA will find it difficult to establish effective processes for dropping some firms from the list for supervision and adding the right new ones.

Supervisory conflicts

As stated above, we are concerned that HM Treasury's pays relatively little attention to supervision and enforcement and hope that this will be addressed in future.

Additionally, where proposals are made relating to supervision, we are concerned that HM Treasury's is over-optimistic about the likely efficiency of a coordinated approach.

Paragraph 5.67 on p.91 reads 'Where 'solo' prudential supervision of firms within the consolidation group is split across the PRA and the FCA, the regulators will coordinate their activities appropriately to carry out effective consolidated supervision, consulting each other as appropriate, as required by the general duty to coordinate.'

It is unlikely that this will work well in practice without the benefit of much greater thought and planning, though we accept that this might be done best outside of the regulatory framework.

We have additional concerns about the proposal (in 5.59) that both the PRA and the FCA should have the power to make rules applying to the same function within individual firm (as a consequence of dual regulation). HM Treasury's document breezily notes 'It is important, therefore, that the PRA and FCA consult each other prior to making such rules, to ensure a consistent and coordinated approach.'

The approach to approved persons also looks confused. Paragraph 5.48 reads 'For firms regulated by both the FCA and the PRA, the Government proposes that lead responsibility for controlled functions will be split between the PRA and the FCA in line with their objectives. Both authorities will have the power to specify new controlled functions and to approve or prohibit any individuals from carrying on these functions or regulated activities.' Despite the different areas of interest in terms of controlled functions, this approach provides the opportunity for confusion as to who is or is not an approved person, for which functions and under whose authority.

Financial Conduct Authority

We welcome the decision to name the new conduct regulator the Financial Conduct Authority, support the FCA's strategic objective and its operational objectives and applaud the determination to take a more interventionist approach where potential consumer detriment is identified.

HM Treasury's document lists a number of new tools and approaches relating to conduct of business regulation. CFA UK has mixed views on these.

Product banning

Though we understand the proposed aims in relation with this power, we are concerned that its use will, in practice, lead to considerable detriment for those individuals that have already bought a product. Liquidity in a banned product will be minimal. Unless a product can be banned at launch or very shortly thereafter, the FCA will have to be extremely careful in its decisions around banning.

Withdrawal of misleading promotions

We believe that the proposed powers will be extremely valuable and support the proposed approach.

Publication of enforcement actions

While we accept that the power to publish the fact that a warning notice has been issued might be broadly beneficial, we would encourage the FCA only to publish where there is extremely strong, almost uncontested evidence of an action requiring enforcement. Paragraph 4.89 indicates that the expectation will be that publication will go ahead unless doing so might not be compatible with the FCA's objectives.

We believe that this would be unwise. First, it might discourage the FCA from issuing warning notices other than in cases where it is certain that enforcement will follow. That may have a negative impact on the FCA's achievement of its objectives. Secondly, there is a danger that consumers and other market participants will react immediately to publication of a warning notice. Even if a business is later subject to a notice of discontinuation, the effect on that business will be extremely damaging.

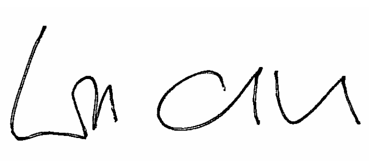
<u>Oversight of client assets</u>

We welcome the decision that protection of client assets will remain a regulatory priority and that the FCA will continue the intensive approach adopted by the FSA's specialist Client Asset Unit.

We trust that these comments are useful and would be pleased to meet the HM Treasury to explain or to develop them for further with the policy team.

Yours,

Natalie WinterFrost, CFA FIA
Chair Professional Standards & Market Practices
Committee, CFA UK



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