CFA UK is a member society of

Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

1st September 2011.

Dear sir/madam,

The Chartered Financial Analyst Society of the United Kingdom(CFA UK) welcomes the opportunity to respond to the Financial Services Authority's consultation on the Financial Conduct Authority's (FCA) Approach to Regulation.

The society represents investment professionals in the UK, most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). This response has been prepared by CFA UK's Professional Standards and Market Practices Committee. The society has not surveyed members in relation to this consultation.

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of whom more than 90,000 hold the Chartered Financial Analyst (CFA) designation.

Response to the consultation

The events leading up to and after the recent crisis demonstrated that the quality of the market for UK financial services had been undermined. Systemic governance failures resulted in inappropriate conduct that often placed firms' interests ahead of their clients. Trust and confidence reached low levels. CFA UK welcomes the FCA's role in attempting to enhance consumer protection and improve the efficiency and choice in the UK market for financial services. However, while we broadly support the FCA's proposed strategic and operational objectives, we are concerned about a number of issues:

- We are concerned that the proposed approach places insufficient emphasis on the demand side of the market for financial services.

- We are concerned that the FCA – as a catch-all for the parts of the previous regulatory framework not captured by the Prudential Regulatory Authority – may struggle to focus on a disparate set of responsibilities.

- We are concerned that the reduction in direct supervision (and its replacement with increased market analysis) may not bring the improvements that the FCA expects in terms of information gathering. This in turn may lead to further regulatory failure and a loss of confidence in the new body.

Taken together these concerns also indicate that the potential for moral hazard to be realised has not been significantly reduced.

Insufficient emphasis on demand

The FCA's aim is to enhance the quality of the market for financial services. This requires more effective interaction between demand and supply. Consumers need to be a more effective source of market discipline on firms and the FCA should aim to maintain a high quality of supply.

On the supply side the aim should be to encourage the quality of supply and quality of suppliers. The FCA's role should be to focus on firms acting appropriately so that the services and products they supply meet a client need rather than the firm's need. Where firms continuously detract from market quality the FCA should consider removing the firm's permission. By allowing the reduction of lower quality firms the overall quality of suppliers that remain will rise.

On the demand side, the FCA can help consumers by educating them with regard to how to identify the right types of products, services and firms that are appropriate to their needs. The FCA should devote more energy to ensure that consumers are becoming a more capable and a more effective source of market discipline on firms.

Meeting disparate responsibilities

CFA UK welcomes many of the ambitions and objectives cited by the FCA, some of which reflect the suggestions included in our responses related to the new regulatory framework for financial services and product intervention. However, the paper provides insufficient evidence as to how the FCA will carry out its duties effectively given its objectives (some of which may conflict with each other). It would be useful for the FCA to demonstrate how it would have approached regulating the market within its scope differently in the period leading up to the crisis and to what extent it could have reduced the negative impact on market integrity and consumer protection. The examples cited in the paper provide little comfort because:

a. The actions provide a further reminder about the lack of effective regulation by the FSA and its predecessors.

b. There were large firms unafraid of taking regulatory risks; some firms were willing to place their interests ahead of their customers and were doing so for a considerable period before the regulator eventually took notice let alone took some action.

Identifying the lessons from the past is not the same as learning from them. The UK financial regulator is often slow to react. In the cases cited (and some others not mentioned) the regulator was slow to respond until significant detriment had occurred. For example, the PPI issue began in 2000, yet it has taken until 2011 to obtain redress. The FSA did not learn from the regulatory failings and inertia that took place in the 1980s and 1990s and its own inertia over split capital trusts and precipice bonds. We suggest that the FCA do further work to persuade the industry that regulatory inertia will not recur and that it will learn from past regulatory failings. The FCA, like the FPC and PRA, needs to demonstrate that this time it really will be different.

Reduced direct supervision

The FCA's proposed scope is considerable. The FCA will have to contend with nearly all of the current FSA's remit aside from prudential regulation for banks and insurance companies. If the FSA, with its resources, was unable to regulate effectively, the FCA will need even more and higher quality resources to be an effective regulator. The FCA has ambitious personnel requirements and wants to be proactive, but the consultation document contains little detail on how the FCA will be able to do this effectively.

CFA UK welcomes the proposed risk-based approach to regulation, but the FCA needs to demonstrate how it will improve on the outcomes achieved when this same philosophy was used by its predecessor. CFA UK supports the FCA's desire to focus on root causes rather than symptoms and also supports the intention to intervene at the product level (though this is something of a mixed message, especially when the more important issue is whether or not firms are acting in the spirit of the regulation rather than within the letter of the rules), but we are concerned about the FCA's ability meet both of these objectives.

Great faith is placed on the capacity for business and market analysis to identify areas of concern and to support effective supervision and enforcement. We do not doubt the value of business and market analysis and accept that, with close to 27,000 firms to supervise, the FCA has little choice but to adopt this approach. However, the consultation document provides too little information about how the business and market analysis team will be able to assess whether or not firms are willing to take regulatory risks.

Section 5.12 of the document states 'the FCA will aim to have direct regulatory contact with all firms through an approach that will be differentiated according to how the FCA categorises firms but with elements of consistency across them.' However, the paper goes on to make it clear that 'overall, the number of firms supervised on a 'relationship managed basis' will be significantly reduced.' The reduced level of direct contact between the FCA and the firms that it regulates will likely reduce the quality of the information available to the FCA. The FCA's reduced access to information makes it more likely that regulatory failures will occur that will damage confidence in the FCA and make it more difficult for the FCA to meet its proposed objectives.

Conclusion

As stated above, CFA UK supports the FCA's proposed strategic and operational objectives but is concerned that these are too broad to allow proper organisational focus, is worried that they put too much faith in analysis over direct supervisory contact and is disappointed that the document places little emphasis on the opportunity to improve the market for financial services through demand-side activity.

Last, the tripartite structure of the previous regulatory framework – and the consequential failure of communication and coordination – is often cited as a factor in the financial crisis. Our own view is that while communication and coordination could clearly have been improved, the real regulatory failure prior to the financial crisis was in failing to supervise effectively either due to a lack of information or an unwillingness or inability to act on information. The consultation document comments on the FCA's relative willingness to intervene (enforcement), but does little to suggest that the supervisory framework will be much improved over that at the FSA. In addition, significant levels of coordination will still be required within the proposed new framework.

The chart on page 41 demonstrates how much co-ordination the FCA will need to undertake. CFA UK would like to see more evidence of how the new framework will deliver more effective co-ordination between its various parts. It is unproven that the FCA or the new framework will reduce moral hazard. Early intervention is the most effective approach to reduce moral hazard, however, the FCA, PRA and FPC need to demonstrate that the new framework will do this. In addition, there is no mention of a regulatory dividend for those that act appropriately. A case study that demonstrates how the FCA, PRA and FPC will be more effective than the Treasury, Bank of England and the FSA were in the years leading up to the crisis would be of great interest.

We trust that these comments are useful and would be pleased to meet with senior FCA officials to explain them or to develop them.

Yours,

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Committee, CFA UK

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