CFA UK is a member society of

Rt. Hon Andrew Tyrie
Chairman of the Treasury Committee
House of Commons
Committee Office
7 Millbank
London
SW1P 3JA

27th January 2012

Dear Mr. Tyrie,

The Chartered Financial Analyst Society of the UK (CFA UK) supports the general thrust of your letter to the Joint Committee Financial Services Bill dated 25th October 2011. Elements of your letter resonate with key areas of concern CFA UK has expressed both to the Treasury and the Joint Committee[1] about the new proposed regulatory framework.

CFA UK also welcomes the recent report by the Joint Committee which set out several recommendations to address the concerns that have been raised. However, despite the emphasis placed on operational excellence rather than a change in framework; it appears that the "Twin Peaks" structure is still being supported.

We recently distributed a position paper to our members on 'Effective Regulation'. The paper sets out the characteristics of an effective regulatory environment. The paper (attached with this letter) forms the foundation of this letter to you.

This letter has been prepared by the CFA UK's Professional Standards and Market Practices Committee. The society has not surveyed its members. We make observations and cite evidence that we believe to be important and which we hope will be useful in informing the UK Government and the relevant Parliamentary Committees to reduce the risks and consequences of future financial crises.

[1] CFA UK response to Financial Services Bill – call for evidence
https://secure.cfauk.org/assets/2481/CFA_UK_response_Joint_Committee_call_for_evidence_FINAL.pdf
CFA UK response to Product Intervention
https://www.cfauk.org/assets/2126/CFAUKresponseProductIntervention.pdf
CFA UK response to the HM Treasury's new approach to financial services regulation
https://www.cfauk.org/assets/2286/Response_to_HMT_New_Approach_to_Financial_Regulation_April_2011SENT.pdf
CFA UK response Financial Conduct Authority
https://www.cfauk.org/assets/2126/CFA_UK_response_FCA_FINAL.pdf

Ineffective regulation

"Our new regulatory approach will be proactive and preventative, aiming to head off problems in advance." (Howard Davies, FSA Chairman, 2000)[2].

"We can do a lot better job than in the past… There were warnings, from this institution (Bank of England), some from the FSA, many from abroad, and yet no one picked up the warnings and ran with them." (Paul Tucker,2011)[3]

The frequency of market failure places a greater onus on the regulator to be more effective in encouraging and imposing market discipline. Sadly, regulators focus on the symptoms of failure rather than its root causes. Furthermore, regulators often ignore the root cause of their own inability to act promptly and thereby contribute to the risk of systemic governance failure. The drive to introduce a new framework via the Financial Services Bill is another example of a failure to address root causes by focussing solely on symptoms.

Effective regulation

"The strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure." (La Porta et al[4])

Effective regulation involves the design of policies, rules and laws that are successfully monitored and supported by the credible threat of enforcement. The new framework is focused on new architecture rather than making the existing one work more effectively. The tripartite system failed because insufficient emphasis was placed on supervision and enforcement. In our opinion, the risks of regulatory failure have not been reduced.

CFA UK believes that effective regulation is essential for the laws of demand and supply to function appropriately. History has demonstrated that market discipline cannot be reliably imposed by all regulated financial firms. The high risk of market failure makes the regulator the last line of defence for maintaining market integrity and thereby trust and confidence. Sadly, the evidence demonstrates that the regulator is also prone to failure. CFA UK calls upon regulators to learn from financial and corporate history and to make material changes in their regulatory approach to deliver the following outcomes:

1) Firms conduct themselves to the highest professional and ethical standards and place clients' interests first.

2) Enhance financial capability so that consumers become a more robust source of market discipline on firms. It is essential for the demand side to be a source of market discipline. Caveat emptor has to be balanced with caveat venditor.

3) Establish a regulatory philosophy and approach which acknowledges that we live in a world populated by people who do not always act rationally and imperfect markets. Rather than facing a binary choice of market mechanism or command and control, the philosophy should embrace asymmetric paternalism. This would create an environment of market command with robust control mechanisms and

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[2] http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/009.shtml

[3] http://www.bbc.co.uk/news/business-13782849

[4] La Porta, Rafael, Lopez de Silanes, Florencio, Shleifer, Andrei and Vishny, Robert W., "Investor Protection and Corporate Governance" (June 1999). Available at SSRN: http://ssrn.com/abstract=183908 or DOI: 10.2139/ssrn.183908

make it possible for firms to fail without endangering the system or imposing major costs on the rest of society.

Just like regulated firms, senior regulators should also be held to account. However, along with the senior managers at financial firms that had engaged in inappropriate activity, very few senior regulators have been held to account following the crisis.

By improving the quality of the regulatory environment, the level of trust and confidence can be raised. The onus will be on each generation of regulators to learn from the mistakes of their predecessors. By fulfilling the essential role they play in enhancing the quality of market integrity, regulators will be able to further strengthen the UK's position as a leading global financial centre.

Below is our opinion as to whether the draft legislation will or could do better.

- prevent another financial crisis

"We can't hope to prevent financial crises from happening, but we can build institutions that help to ensure that our financial system is more resilient in the future." (Mervyn King)[5]

CFA UK agrees with the view that crises cannot be prevented. The key issue is how the new framework being proposed can reduce the frequency and/or severity of crises; can implement effective mechanisms to handle crises; and minimize crises' adverse consequences on the rest of the economy and society.

- handle a financial crisis

Before finalising the new legislation it would valuable for the government to produce some evidence to demonstrate how the new framework would have delivered a better outcome than the existing tripartite system in the following areas:

1) Reduce the threats to market integrity and trust.
2) Ensured that those responsible would be held to account.
3) The costs to the taxpayer and the wider economy would have been reduced.

The new framework relies on rhetoric to demonstrate that it can handle the next crisis. Neither the UK Government, nor the FSA has produced evidence to demonstrate how the proposed architecture would have been more effective in handling the last crisis, let alone the conduct failures that continue to come to light. More evidence is required to demonstrate that the proposed regulatory architecture would have done a better job in addressing the root causes of the financial crisis.

CFA UK agrees with you that we have a once in a generation opportunity to get the legislative framework right. We add three points –

1) Caveat emptor should be balanced with caveat venditor : The new framework does not overcome the deficiencies of the tripartite system: CFA UK has regularly stated that it is the efficacy of the framework that matters. The proposed reforms do not demonstrate how the new structure would have been more effective than the tripartite system. The failure of the tripartite system was due to the lack of supervision, enforcement and reluctance to take responsibility. The new framework does not address these challenges. Perhaps, it may be more cost

[5] http://www.telegraph.co.uk/finance/economics/8597139/Financial-Policy-Committee-the-key-quotes.html

effective to make the current system work more effectively. In addition, more could be done to make the demand side of the financial services market a more powerful source of market discipline on financial firms. There is an overemphasis on the supply-side.

2) Evidence based policy-making: There is little in the way of evidence that the new framework will be more effectively supervised or have a more credible threat of enforcement so that costs of inappropriate behaviour will materially exceed the benefits of such activity.

The Treasury needs to provide to demonstrate how the new framework would have reduced the risks and costs imposed on the rest of society by inappropriate activity in the financial sector

3) Accountability: Holding regulators to account is important. In common with the treatment of senior executives at some financial firms, the senior regulators that were supposed to be guardians of the financial system have not been held responsible. This does not inspire confidence that, in the new regulatory regime, these same senior regulators will be held to account more effectively.

We would welcome the opportunity to collaborate with the Treasury Select Committee and the Draft Financial Services Bill Joint Committee to discuss (and where appropriate develop) the issues raised in this letter. Will Goodhart's secretary will give you a call next week to arrange for such a meeting to present our findings. It is our hope that through collaboration with the City, the Treasury Select Committee can help create an effective regulatory environment that enhances market integrity; restores trust and confidence and supports the UK as a global financial centre.

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 most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). 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 106,000 members in 135 countries, of whom more than 97,000 hold the Chartered Financial Analyst® (CFA®) designation.

Yours,

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