The Financial Services Authority: looking back, looking forward.

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This note looks at the work of the Financial Services Authority (FSA) in light of the statutory two year review of its operations, a recent National Audit Office (NAO) assessment and at the start of the FSA's own new 'principles based approach to regulation.

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Standard Notes are compiled for the benefit of Members of Parliament and their personal staff. Authors are available to discuss the contents of these papers with Members and their staff but cannot advise others.

A. Introduction

There are three main sources for evidence about the work of the FSA; a Treasury review held two years after it came into force; an NAO report into its effectiveness, and from the statements and responses made to criticism by the FSA itself.

B. The two year review

The impetus for a formal review of the regulatory system was a recommendation in the Cruickshank Report - *Competition in UK Banking* – which was published in March 2000. The banking review had largely coincided with the passage of the *Financial Services and Markets* bill as it 'wended' its way through Parliament. Cruickshank recommended that " the Government should monitor the impact of the FSMA on competition in financial services markets and conduct a formal review, two years after commencement legislation".[1]

The *Financial Services and Markets Act* (FSMA) *2000* came into force in December 2001. and the review of the FSA was announced by the then Financial Secretary, Ruth Kelly, on November 2003.[2] The Government took the opportunity of a Review to expand it beyond the competition boundaries of concern to Cruickshank so that all aspects of the FSA's operation might be considered. By way of response

The Minister had said (see above), "I expect the FSA to report on the outcomes in its forthcoming Annual Reports" in fact the FSA proceeded to institute a full scale consultation process of its own covering possible reforms to itself and the FOS. In July 2004 it issued a consultation document (CP04/12) with the following remit

> As part of the two-year review of FSMA led by HM Treasury, the Financial Secretary to the Treasury asked FSA and FOS to review:
>
> • the circumstances in which FSA takes regulatory action instead of individual cases being determined by FOS; and
> • whether, in specific circumstances, FOS decisions should be subject to some form of appeal.
>
> The Financial Secretary made clear that the two-year review of FSMA is of a framework that works well; the Government are not looking to fix a system that is failing. For this reason the Government does not intend to change the structure established by FSMA and is not seeking primary legislation to do so. The Financial Secretary also noted the importance of the service provided by FOS and said that changes should only be made after careful consideration. She said she would not favour changes that:
> • undermined FOS's independence of the regulator, the industry and consumers;
> • meant that FOS was not free to consumers; or
> • required FOS to consider cases other than on their merits.[3]

The responses to the full consultation paper are available on the FSA's website at: http://www.fsa.gov.uk/pubs/cp/cp05_04.pdf

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1 Op cit p xi
2 HC Deb 4 November 2003 WS c28 & Dep 03/2550
3 FSA website, Newsletter 04/12 http://www.fsa.gov.uk/pubs/cp/cp04_12_newsletter.pdf

Simplifying enormously, three main issues were discussed in it:

- How did the FSA and FOS deal with difficult issues, issues that had in the jargon 'wider implications'?
- Should the FSA make more use of test cases?
- Should there be an external appeals mechanism for FOS determinations?

Concluding its response and those who responded to the paper the FSA noted:

> The key messages from the responses were:
>
> – There was strong support for greater transparency to explain: what is meant by wider implications; how stakeholders can identify such cases to the FSA and the FOS; how stakeholders can put forward their views and concerns; and the respective roles of each organisation.
> – In cases where the FSA became involved, there was widespread support for telling interested parties what had been done. This was subject to some respondents' concerns about protecting commercial confidentiality and wider market confidence, especially while cases were still under consideration.
> – In cases where the FSA did *not* become involved, there was widespread support for the FOS to seek (in a flexible way) input through an industry expert, nominated by the chairman of the relevant industry liaison group, and a consumer expert. Those experts could draw more widely on industry and consumer viewpoints.
> – In both eventualities, and while supporting the measures the FSA and the FOS had proposed in the CP, a number of respondents suggested further improvements to the handling of wider implications issues and to the transparency of the process.
> – Most respondents were in favour of the principle of test cases in limited circumstances, particularly where the case turns on a point of law. However, most thought that test cases would be used very rarely, not least because of the potential costs involved.
> – There was little support for creating an external appeals mechanism, save among smaller firms and those representing them. Many of these respondents wanted an external appeal to be available in *all* cases, and not just where there were wider implications.
>
> 2.5 In the light of these responses, in Chapter 6 of this paper we set out updated arrangements. These clarify how – so far as is consistent with our separate and independent roles – the FSA (as regulator) and the FOS (as dispute-resolver) will cooperate in dealing with wider implications cases.
> – These involve improvements in FSA and FOS processes and improved transparency.
> – Where a case remains with the FOS, the focus is on improving the process before an ombudsman decision is made.
> – There will be provision for test cases in the rare instances where these are appropriate, but no provision for an external appeal mechanism.[4]

a. Regulation

As a separate exercise, the FSA looked at the general issue of regulatory overload, of both rules and consultations.

Stories about the size of the FSA rule book are near-legendary. According to recent reports it has been reduced now to a mere 8,800 pages.[5] The sheer volume of material emanating

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[4] FSA website, Response Paper published March 2005, available at: http://www.fsa.gov.uk/pubs/cp/cp05_04.pdf

[5] Reported *Financial Times* 22 June 2007

from the FSA is impressive. The number of consultation and discussion documents issued in recent years is shown in the table below:

FSA Documents issued

	Consultation papers	Discussion documents
2000	79	4
2001	118	10
2002	163	11
2003	209	12
2004	18	2
2005	14	5
2006	21	6

Source: FSA Website

The FSA have certainly addressed the regulation issue and implicitly therefore acknowledge a possible problem, both in terms of volume and depth. Its Chairman, Callum McCarthy, has stated that:

> "We are determined to be more rigorous about the costs and burdens that regulation imposes on firms. We are also simplifying our Handbook requirements and the way we express them, which will help all firms but particularly smaller ones who do not have access to expert advice. It sits alongside other major initiatives we have in hand to make us an easier organisation to do business with such as Firms Online, Integrated Regulatory Reporting and the shorter application packs which will reduce the time and effort firms need to spend in dealing with us."
>
> "We will continue to gather views from all our stakeholders about how other parts of the Handbook can be improved to deliver better regulation in practice." [6]

At the 2005/06 annual general public meeting, the Chairman announced that in response to criticism that the rulebooks were too onerous:

> To that end, we have produced tailored handbooks for each of 14 individual sectors, bringing together the regulations needed for example by someone engaged in asset management or as a general insurance broker. These handbooks are typically about one tenth of the size of the FSA's overall handbook. When we revise handbooks, we take the opportunity to shorten them: the new listing rules are one-third shorter than those they replace; the new Collective Investment Scheme rules are half the size of the old.[7]

The impetus to make dealing with the FSA easier became more urgent following the huge increase in the number of regulated individuals following the expansion of the FSA's responsibilities. As the Business Plan 2005/06 pointed out:

> At the beginning of this financial year we regulated about 10,700 firms. Following the introduction of mortgage and general insurance regulation the numbers have increased to about 25,000. Of this total 97% do not have an FSA relationship manager and so can be regarded as small firms.[8]

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[6] http://www.fsa.gov.uk/pages/About/what/regulation/index.shtml

[7] FSA website: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0721_cm.shtml

[8] FSA Business Plan 2005/6 p 31

In the 2006/07 Annual Report the Chairman commented:

> We continue to review our existing regulations, to see where we can eliminate regulations we judge unnecessary, or replace specific rules with reliance on principles. And we continue to adopt policies which are risk based and proportionate. We accept that we cannot achieve, and that it would be counter productive to pursue, a zero-failure approach. Investment involves risk, and risk entails occasional failure.[9]

The review of the rules handbook is ongoing. According to the FSA the review will be guided by the following principles:

> Focusing on making changes in areas where we can have real impact and only respond to suggestions to make changes to individual Handbook provisions where the benefits are clear;
>
> Taking advantage of opportunities to streamline the Handbook as they arise – for instance, where these is scope to redraft material when implementing a directive. We are already using the opportunity provided by MIFID to simplify our COB regime;
>
> Adopting high-level standards where these are more appropriate than detailed rules. Benefits arise from focusing our attention on senior management responsibilities and allowing firms greater flexibility in some areas; and
>
> Ensuring that we do not leave firms without guidance that is useful.[10]

The FSA has actually commissioned research in its defence to find out how much regulation actually costs regulated companies. Surveys by the Financial Services Practitioner Panel found that "58% of smaller companies estimated regulatory costs were more than 10% (of total costs). Even among larger groups, the proportion was 35%".[11]

In a memorandum to the Treasury Select Committee the FSA said of its regulatory function:

> Better regulation
>
> Our better regulation work aims to deliver regulation that meets our statutory objectives in a way that is as risk-based and cost-sensitive as possible. We support the Government's better regulation agenda, which accords with our pre-existing commitments and the work we have been doing for some time in this area.
> In areas where have reviewed our regime, we have sought to both liberalise markets and move to a principles-based approach. Examples of this in practice are our 'Listing principles', where we have introduced a set of six principles for listed companies (which has resulted in a 40% reduction in the size of the rulebook for listed firms), and our 'treating customers fairly' initiative which encourages firms to develop their own approach rather than complying with detailed rules. There will be times, however, when we continue to use detailed rules. We will need to do so, for example, in order to implement the detailed requirements of EU directives.
>
> We continue to seek to achieve targeted reductions in our rules. As part of this, in July this year, we set out proposals for change in three areas: money-laundering, our approved persons regime, and training and competence arrangements.
>
> We are also carrying out, in partnership with the Financial Services Practitioner Panel, a study to establish robust estimates of the costs of financial services regulation on firms in the UK.

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[9] FSA Annual Report 2006/07 http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/075.shtml

[10] http://www.fsa.gov.uk/Pages/About/What/regulation/principles/index.shtml

[11] *Financial Times* 26 May 2005

> This study is analysing the impact of regulation on firms' operating costs and what firms would in any event incur as part of their day-to-day operations. The study, being undertaken by independent consultants, covers three sectors: retail advice, investment banking and institutional fund management.[12]

In evidence to the same Committee the Chairman and Chief Executive of the FSA gave an example of where regulation had been imposed on one level but where experience suggested that it could be scaled down:

> ***Mr Tiner:*** I think, clearly, we started regulating general insurance as a result of the Insurance Mediation Directive that was enacted here in January 2005, and this covered the whole waterfront of general insurance activities from the London wholesale market to dentists who were suggesting that their patients should take out some dental insurance cover. I think it has become apparent to us in the 18 months or so since that there are a number of product areas which do not require the full rigours of the Financial Services and Markets Act, which is how the IMD was implemented in the UK, in order to secure the necessary protections for consumers, and I think we think of those sectors as the motor insurance sector, the household insurance sector and the sort of pet, dental or optical areas where, quite frankly, the market works reasonably well, and I think a much reduced regime down to the minimum of the Directive rather than the full rigours of the Financial Services and Markets Act would be fine, in our view.[13]

Although not part of the Two Year Review, note should be made here of changes to the *FSMA* by the 2007 Regulatory Reform Order. A consultation process had begun in December 2005 the results of which were put out for a second round of consultation in May 2006.[14] They were finally considered, and approved, by the Regulatory Reform Committee in June 2007.[15] The main changes were:

> The proposed Order would remove or reduce burdens in the following areas:
> • authorisation requirements in relation to partnerships whose members change [Article 3]
> • unnecessary consultation between the FSA and regulators in other countries in the European Economic Area [Article 4]
> • obligations on the FSA to fulfil a number of procedural requirements associated with discontinuing or suspending the listing of a security [Article 5-7 and 11]
> • requirement on the FSA to issue a warning notice in cases where the cancellation of a sponsor’s approval has been requested by the sponsor himself [Article 8]
> • the FSA’s powers to waive or modify any (as opposed to some) of its rules in respect of authorised and unauthorised persons [Article 9]
> • obligations of the FSA when consulting on guidance [Article 1] and
> • power of the FSA board to delegate the issuing of guidance [Article 12]

b. Discipline

The FSA has also had to make substantial changes to its disciplinary procedures prompted mainly by the following the court action against it in the case involving Legal & General in

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[12] As yet unpublished evidence to treasury Select Committee hearing of 8 November 2005
[13] Treasury Committee HC 1594 i ev 20
[14] HM Treasury Library Dep MGP 06/1352
[15] HC 673 available at http://www.publications.parliament.uk/pa/cm200607/cmselect/cmdereg/397/397.pdf

January 2005. The case involved a £1.1 million fine for L&G breaking rules in the sale of low cost mortgages in the 1990s. The Financial Services and Markets Tribunal found that the FSA had come to its conclusions on the basis of far too little evidence.

In the Two Year review mentioned above *The City Liaison Group*: made a specific comment about the way that the FSA conducted disciplinary proceedings:

> Status/role of FSA's Principle 11 in a disciplinary context (particularly problematic when criminal action is possible - see below).
>
> Tensions where both regulatory and criminal action possible Allied to the point raised above is the difficulty that arises when, as is often the case during the early stages of an investigation, it is not clear whether the FSA intends to take regulatory or criminal action against a firm. In a criminal investigation, a party has the right to remain silent and to rely on the privilege against self-incrimination. Further, evidence obtained under the exercise of compulsory powers cannot be used against a defendant in subsequent criminal proceedings. This protection could be relied upon by a party under investigation if the FSA had compelled the production of information, but it may not be able to be relied upon if a firm had given voluntary disclosure under its Principle 11 obligations unless it is clear that the firm could argue that *in fact* – because of its regulatory obligations – it *had* been compelled to provide the information.
>
> Preliminary findings letters (PFLs)
> In theory these letters should only deal with factual points. However, in practice the law firms are finding that the FSA often produces 'hybrid' documents, setting out both factual statements and conclusions or setting out factual statements selectively – for example the documents often do not provide an objective assessment of the *totality* of the facts put before the investigators – or generally but in a way which is calculated to lead to a particular conclusion. This means they are difficult to respond to and, because the FSA does not go on to set out what consequences are likely to arise from the conclusions reached, it is not clear whether the party under investigation should be advised to take issue with those conclusions.
>
> The same point often arises even if the PFL does only set out factual points. It is difficult to know how to respond to a letter (and what factual information will be relevant in such a response) when it is unclear what will be alleged on the basis of the facts set out. For example, it is often unclear whether the facts set out in a PFL will lead to allegations of systems and controls breaches, negligence, or criminal activity. It is therefore very difficult to establish what factual evidence will be relevant in response. This problem would not arise if FSA's initial conclusions were separated from the account of the facts: the latter could then focus on providing an objective account of the events that have led to the case.
>
> In addition, firms are asked to comment on the facts but may not have all the evidence on which those facts are purportedly based – e.g. because the FSA has taken documentary or witness evidence from third parties which it is not *required* to disclose unless or until a warning notice is issued later on in the process. Clearly, strictly speaking, FSA is able to refuse to disclose this information at this early stage, on the basis that the disclosure obligation arises only later, but this plainly hampers the firm's ability sensibly to comment on the PFL and ultimately prevents the PFL from fulfilling its purposes of seeking to attain agreement as to the facts, so far as possible.
>
> Overall, the role of the PFL needs to be clarified: PFLs should provide a self-contained objective account of the facts and a preliminary view of the likely consequences of the findings so as to avoid these problems. In addition, it would be helpful to confirm the circumstances in which a party could ask the FSA to clarify the PFL.
>
> It should be noted, in this context, that there are concerns that the RDC process can be too cumbersome. For example, reconvening the panel within a reasonable period of time can be extremely difficult given people's diary commitments. Steps to focus the issues at stake through improving the PFL procedures should help to reduce this difficulty.

Other aspects of the RDC's procedures

If firms are to have a fair opportunity of putting forward their case (which is their statutory right), then they must know precisely what the case is that they have to meet and this involves knowing what case the FSA has put forward to the RDC. There is a concern, however, that the emphasis on the administrative – rather than judicial – character of the process may have resulted in firms not being given the opportunity to respond to additional points made by FSA staff which have not been raised in the documents disclosed to the firm, or which result from the firm's representations. Currently, there is unease that firms may not have access to all the material which is before the RDC as a matter of course and that it can be necessary to do battle with the FSA in order to see this material.

Limitation periods

There is a limitation period for proceeding against individuals but not firms. We believe there should be a limitation period for proceeding against firms as well for two main reasons:

(i) even if only the firm is pursued, individual employees may still suffer reputational damage; and
(ii) the current discrepancy may lead the FSA to pursue a firm because it can no longer pursue the individual, when the individual is in fact the most appropriate target.

Given our first concern, the protection afforded to the individual by the limitation period can be eroded *in practice* because there is no similar limitation period for firms. In addition, a limitation period for proceedings against firms may have some influence on the way FSA prioritises work on enforcement cases.

Conclusion

Overall, firms' perception of the RDC is important, and, in particular, it is essential that it does not appear to be a "rubber stamp" and that those who undergo the process come away with the impression that they have been fairly heard. Currently, however, it seems that there *can* be concerns about the fairness of the process and, even though these may not always be legitimate and may not do justice to the FSA/RDC, it would be unfortunate – and potentially damaging – if the steps that could be taken to reduce the concerns were not explored fully. It would be more unfortunate still if, in an attempt to reduce the time taken to reach decision notice stage, additional shortcuts to the RDC's consideration of a case were to be introduced.[16]

The upshot has been an 'enforcement process review' which reported in June 2005. The *Financial Times* reported the outcome:

> Sweeping proposals for change announced yesterday amounted to an admission that the regulator's first stab at implementing the law had been flawed.
>
> Taking as its cue the law set out in the Financial Services and Markets Act, the FSA in 1998 began to establish an elaborate framework and set of procedures for investigating and, if necessary, penalising wayward groups.
>
> But Sir Callum McCarthy, FSA chairman, said yesterday: "If we had the experience we now have seven years ago we would have designed it differently."
>
> Confidence in the fairness of FSA enforcement had been undermined by the regulator's mortgage endowment mis-selling case against Legal & General, he admitted. In January an independent tribunal criticised the FSA's handling of the case, upholding only some of the original charges and eventually halving a Pounds 1.1m fine.
>
> "There is a sense that people do not believe they've been treated fairly," said Sir Callum. "I don't expect people to be happy they're being subject to enforcement, but I do expect people to be able to say grudgingly that the process has been fair."

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[16] City Liaison Group, Response 4

> The FSA is proposing to introduce new checks and balances and improve the transparency of the enforcement process. But at the heart of its plans is a point spelled out for the past seven years in the Financial Services and Markets Act, but not fully realised - the need to separate the people who prepare enforcement cases from those who make decisions on them.
>
> The regulator's enforcement arm, run by FSA staffers, was supposed to be separate from the regulatory decisions committee - filled with lawyers and representatives from the financial services industry - which decides whether to penalise companies. The two, however, operated almost as sister departments. The enforcement team was in regular contact with the regulatory decisions committee through various informal channels and even provided legal advice to the decision-makers out of the sight of companies under investigation.
>
> "Some aspects of the relationship between FSA staff and the RDC are blurred," said David Strachan, the FSA's director of retail firms, who led the enforcement review.
>
> To re-establish the divide, Mr Strachan said enforcement staff would lose their private access to the RDC and that any "substantive" communication between the two groups would be recorded and disclosed to the company under investigation. The RDC - headed by Tim Herrington, a former partner at law firm Clifford Chance - would also gain its own team of two lawyers.
>
> At the same time the group's membership would be cut to 16 from its current 24. "A smaller number of members will mean they are involved in more cases, which will promote consistency of decision-making and lead to more familiarity with the issues," said Mr Strachan.[17]

The full text of the policy changes can be found in the FSA's policy document 05/11 available at: http://www.fsa.gov.uk/pubs/policy/ps05_11.pdf

C. 2005 Pre-Budget Report

Although separate from the statutory two year review described above, this is a convenient place to record the initiatives published with the 2005 Pre–Budget Report (PBR).

The PBR included the *Regulatory Reform Order: A consultation on proposed changes to the Financial Services And Markets Act 2000.*[18] Much of the document contains proposals to simplify the processes the FSA must undertake before it is able to change its regulations, be they rules or guidance. Thus, it is proposed that the FSA need no longer have to consult on all regulatory changes, nor need it consult other EU regulators before it makes changes. To anyone familiar with the process, the way in which the FSA currently effects change, typically, draft proposals issued, consultation responses produced, draft policy rules, new rules promulgated, creates the impression of a continuous wave of documentation. The proposals in the Treasury's document aimed to combat this with the ultimate intention that "the proposals in this consultation document should enable the FSA to develop a more risk-based approach to regulation".[19]

The proposals are summarised below in material taken from the Report.

Consultation on rules

[17] *Planned changes illustrate previous flaws*, Financial Times 20 Jul 2005
[18] available at: http://tinyurl.com/yrnnor
[19] ibid p3

2.1 Section 155 of FSMA requires the FSA to consult publicly before issuing virtually all new rules. The proposed rules must normally be accompanied by a cost-benefit analysis, an explanation of the purpose of the rules, and a statement of their compatibility with the FSA's statutory duties under s.2 of FSMA.

2.2 While s.155 (7) enables the FSA to dispense with consultation (and the requirements to provide a cost benefit analysis, an explanation of the purpose of the rules and a statement of compatibility) if it considers that the ensuing delay would prejudice the interests of consumers, there are no further exemptions. This causes two problems, namely:
1. Prejudicial delay to others: the FSA must consult even when it considers that the delay caused by consultation would prejudice the interests of firms and others subject to the rules; and
2. Consultation for no useful purpose: the FSA must consult where this serves no useful purpose, e.g. to correct a clerical or drafting error, or where the change has only a minimal effect on the regulatory regime.

2.8 We therefore propose to extend the circumstances at s.155 (7) in which the FSA is not required to consult on rules (or to comply with the obligations in section 155(1) to (6)) to include the following;

where the FSA considers delay in making the rules is prejudicial to the interests of anyone affected by the rule (rather than just prejudicial to consumers);

where the FSA considers the changes have a minor effect. One option would be to provide the FSA with discretion to decide what constitutes a 'minor effect', and perhaps to support this with an FSA statement of policy which might clarify that these changes would only involve for example updating references generally and making changes merely to the form or arrangement of a document but not to its content. Another option, which might be preferable, could be to state in the Order what such changes having a 'minor effect' might be, in particular a minor clarification of existing rules, minor changes consequential upon provisions in domestic or EU legislation, or the correction of a clerical or drafting error.

Consultation on guidance

3.1 Section 157(3) of FSMA requires the FSA to consult publicly before issuing any guidance on its rules. The requirement […] normally be accompanied by a cost benefit analysis, [&…] statement of its compatibility with the FSA's statutory duties.

3.2 While the FSA is excused under s.155(7), as with rules, from consulting on proposed guidance where the ensuing delay in issuing guidance would prejudice the interests of consumers, there are no further exemptions. This causes two problems, namely:
1. Prejudicial delay to others: as with [.the] rules; and
2. Consultation for no useful purpose: […] e.g. when the guidance is to correct a clerical or drafting error, or has minimal effect.

3.6 Our basic proposal [narrow option] is to widen the range of scenarios in which the FSA has the discretion not to consult (or comply with the requirements of section 155(1) to (6)), namely;

where the FSA considers delay in making the guidance is prejudicial to the interests of anyone affected by it (rather than just prejudicial to consumers); and

where the FSA considers the changes have a minor effect. One option would be to provide the FSA with discretion to decide what constitutes a 'minor effect', and

perhaps to support this with an FSA statement of policy which might clarify that these changes would only involve for example updating references generally and making changes merely to the form or arrangement of a document but not to its content. Another option, which might be preferable, could be to state in the Order what such changes having a 'minor effect' might be, in particular a minor clarification of existing guidance, minor changes consequential upon provisions in domestic or EU legislation, or the correction of a clerical or drafting error.

3.7 As with our proposals on rules, the FSA would only be able to use each new exemption if it considered that the proposal did not significantly prejudice the interest of consumers and in the case of the minor effect exemption, other persons subject to or affected by the guidance. Where the FSA does not consult then the additional requirements in FSMA relating to consultation on guidance would not apply, i.e. the requirements set out in paragraph 3.9 of this document.

3.9 Depending on feedback to this consultation, we may enact an additional proposal [broad option]. This would remove the requirement on the FSA, when consulting on guidance, to produce a cost benefit analysis (s.155 (2) (a)), a statement of compatibility with the FSA's statutory duties (s.155 (2) (c)), an account of representations made to it in the course of the consultation (s.155 (5)) and a note detailing how the final guidance differs from the draft circulated for consultation (s.155 (6)).

FSA's requirement to consult on other matters

A similar model of relaxation is proposed for consultations on codes of practice, policy statements, on the imposition of penalties and arrangements for investigating complaints.[20]

FSA's requirement to consult other EEA Regulators

5.1 Sub-section 49(2) of FSMA requires the FSA to consult a European Economic Area (EEA) firm's home state regulator before granting permission to carry out a regulated activity to a person who is connected with that firm; or cancelling or varying such a permission.

5.2 The sub-section implements parts of various EC Directives. However, while the EC Directive provisions were designed to ensure that other European regulators were consulted before authorisation was granted or expanded, s.49(2) over-implements the requirements by compelling the FSA to consult other regulators when cancelling or narrowing a permission.

5.3 The s.49 (2) provisions are burdensome in cases where major financial groups such as insurers and banks apply to cancel or vary permissions since such groups will have authorised entities in many of the other 24 EU Member States. Using the example of a single financial services group, which is made up of 26 UK authorised persons, the FSA had to consult 13 other EEA regulators in 2001, resulting in at least 91 "consultation events". Many of these consultations were not required by EC Directives.

[20] ibid p15

5.4 Exceeding the minimum requirements of EC Directives in this way has resulted in a certain degree of reputational damage to the FSA as EEA regulators have complained about such consultation not covered by EC Directives.

5.5 We intend to amend s.49 (2) to require the FSA to consult with EEA regulators only as required by the relevant EC Directives. This means that we shall;
remove the requirement to consult European regulators prior to cancelling a permission;
remove the requirement to consult where a variation narrows the scope of a permission.

Delegation of guidance

It is proposed that guidance may be delegated to a sub committee of the whole board or even individual officers. Currently the main Board has to scrutinise all issued guidance.[21]

Removing restrictions on waivers

The FSA has the power to grant waivers to its rules on individuals governed by it directly, however, practitioners, governed for example by the Law Society cannot enjoy a similar waiver despite the fact that they are bound by FSA rules. The proposal is that this restriction is abolished.

Simplifying de-listing rules

8.1 FSMA requires the FSA to follow certain procedures prior to discontinuing or suspending the listing of a security. In particular, the FSA must notify the issuer of the details of the discontinuance or suspension (s.78(3)(a)), the reasons for the FSA's decision (s.78(3)(b)), the right to make representations (s.78(3)(c)), the date on which the discontinuance or suspension took, or will take, effect (s.78(3)(d) and the right to refer the matter to the Tribunal (s.78(3)(e)) as provided for by s.77(5)). These provisions implement, in part, Articles 18 and 19 of the EC Admissions Directive (2001/34/EC).
8.2 Clearly, these procedures are appropriate where the discontinuation or suspension has been initiated by the FSA and such action is being resisted by the issuer. However, where the cancellation or suspension is initiated at the request of the issuer, the procedural requirements appear to serve no useful purpose.

8.3 Where the issuer seeks to discontinue or suspend the listing of a security, we propose to remove the obligation on the FSA to fulfil the following procedural requirements; […]
We propose in addition as a consequential amendment to remove the anomaly in section 77(5) of FSMA which allows an issuer to petition the Tribunal about a discontinuation or suspension when that discontinuation or suspension was requested by that issuer. However, in order to protect the rights of the issuer we have inserted provision allowing him to make representations and refer the matter to the Tribunal if the FSA refuses his request to discontinue or suspend the listing of the securities.[22]

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21 ibid p 23
22 ibid p 27

Simplifying the procedure relating to the cancellation of sponsor approval

> **9.1** FSMA requires the FSA to issue a warning notice before cancelling a sponsor's [an FSA approved person performing services on behalf of others] permission – even when cancellation is at the request of the sponsor. Persons in receipt of such a warning notice may appeal to the Financial Services and Markets Tribunal.
> **9.2** The requirement to issue a warning notice is contained at sub-section 88(4). Sub-sections 88(5) and 88(6) proscribe the way the FSA must treat representations made in response to the warning notice; while sub-section 88(7) provides for the right of appeal to the Tribunal.
> **9.3** The notice arrangements presume a contentious background to cancellation. Clearly the arrangements are appropriate where the cancellation has been initiated by the FSA and such action is being resisted by the sponsor. However, where the cancellation is initiated at the request of the sponsor, the requirement serves no useful purpose.
>
> **9.5** We propose to amend s.88 (4) so that the FSA is exempt from issuing a warning notice in cases where the cancellation is at the request of the sponsor. Sub-sections 88(5) to (7) reference the issue of a warning notice and so by removing the need to issue a notice, we shall remove the requirement upon the FSA to follow the procedure set out therein. This means that the sponsor will not have access to the Tribunal.[23]

It is intended that these changes will be effected by an Order under the Regulatory Reform Act.

D. National Audit Office Review

The NAO published its review of the FSA in April 2007.[24] Its recommendations, drawn from the Report's Executive Summary are summarised below:

The FSA was praised for the way it had "developed and is developing useful tools to manage its performance in meeting its objectives in an economic and efficient way". The NAO thought that it did not have good enough systems to either make informed judgements "for prioritising resources at the highest level between its different functional areas, such as authorisation, supervision and enforcement". Also, "It should also monitor regularly the correlation between its risk assessments of individual firms and the amount of resources it uses to supervise those firms." The NAO wanted the FSA's new Outcomes Performance Report, which assesses outcomes based on 111 separate measurements, to be "embedded as fully as possible into regular performance measurement and business management and planning processes".

The NAO thought that "The FSA has good and improving working arrangements with the Office of Fair Trading (OFT), the Pensions Regulator and the Financial Reporting Council, as well as with the Bank of England and HM Treasury in their arrangements for financial

[23] ibid p31
[24] HC 500 2006/07

stability." The FSA's relationship with the OFT was seen as a key relationship. (The FSA does not regulate consumer credit business the OFT does.) It recommended that "The FSA should now work with the OFT to capitalise on their respective strengths and avoid duplication and, in particular, seek to draw on the OFT's competition and market analysis expertise. This coordination could include running parallel projects in areas of common interest, or in some cases creating joint teams". The FSA were also encouraged to "coordinate with The Pensions Regulator to ensure a clear understanding of their respective responsibilities for protecting the interests of pension scheme members and for improving their financial capability".

The role of the FSA as an international influencer was also considered. Its activities in Europe where it had largely campaigned on a 'better regulation' agenda' was praised and its technical and 'political' skills in international fora were praised. Indeed the main criticism the NAO had on this count was that the FSA could sharpen up its communication to stakeholders about its strategy and contribution. Within Europe "It is influential […] and also engages effectively with the European Commission and other member states". On a wider stage "The FSA is a leading international regulator. It has achieved important results in global coordination, for example with the US regulatory authorities on administrative backlogs in the settlement of some types of financial instrument, and it is widely respected for its thought leadership on issues such as risk-based regulation".

The NAO Report said that "combating financial crime has tended to receive less attention than other elements of the FSA's responsibilities." In fact following a report by the FSA into insider dealing there has been considerable interest in this area. The general criticism is that the FSA has not been tough enough. The sight of city executives being paraded in handcuffs on the streets of America has not been replicated in the UK: some say it should. Business leaders, however, claim the FSA's approach as more effective than an alternative, more punitive approach, such as that taken by US regulators The NAO noted that "the FSA devotes under 10 per cent of its resources to its financial crime objective2 which it did not think needed "to increase significantly […] in the short term". It did recommend, however, that the risk of crime should played a bigger role in the overall risk assessment of businesses and therefore crime issues and awareness ought to be spread more broadly across the regulatory structure.

The FSA is described in the NAO Report as "a world leader in financial capability". This work was encouraged by the NAO although they wanted the FSA to try better to "quantify the costs to society and the financial services market of low levels of financial capability to help determine long term plans for its role and resource allocation for this problem". Currently the FSA plans to spend around £90 million in this area between 2006 and 2011.

E. Successes?

It is harder to point out the successes of the FSA. This is not because there are none, but simply because they are more of the 'dog that did not bark' variety. It will not be clear for many years, for example, how effective the new rules regarding the sale of mortgages have been in preventing mis selling. There have been some large fines for companies which have failed to meet, for example, its requirements on money laundering, and yet the benefit of this may never be apparent. Even the evidence can lead to alternative conclusions. Would a large number of heavy fines and disciplinary proceedings indicate that the system was working well or badly?

An obvious success is that the FSA has managed to make the FSMA work as planned. It has taken a fractured system and managed to bring together the staff of nine financial regulators into a single regulator, and to implement a new regulatory regime without significant disruption. As Howard Davies put it in the 2001-02 Annual Report:

> Celebrations in the City of London were muted [on 1 December 2001]. If there were parties we were not invited.
>
> The transition was, as we had hoped, generally smooth. The long period of preparation meant that our systems were able to 'grandfather' the authorisations of some 11,000 firms into the new regime without disruption of their business. And, with a few exceptions, firms themselves seemed prepared for the change. We have also begun to establish our identity with consumers of financial services - though there is considerably more work to be done in that area.

This assessment was broadly endorsed in the 'tribute' articles which appeared when Howard Davies announced his retirement from the FSA in December 2002. The headline on the *Financial Times*' piece, 'Grudging respect for watchdog as he leaves City fray', sums up the views of many of those quoted.[25]

The scope of the FSA has consistently expanded over the years and now only consumer credit sales – regulated by the OFT- remain as a major financial area for which it has no control.

In terms of regulatory 'bite' the FSA has levied large fines on a number of major financial organisations and smaller ones on individuals. In addition, there have been many instances of firms having their authorisations revoked or, more commonly, restricted. The FSA publishes a regular *Enforcement Annual Performance Account.* In its latest Account the FSA outlines its approach to enforcement:

> We use the enforcement tool strategically in support of our supervisory, thematic and market monitoring activities to achieve our objectives. We have very wide responsibilities and limited resources; enforcement is only one of a range of tools available to deal with non-compliant behaviour. And we use it as part of our overall risk-based strategy. We are always keen to ensure our regulatory interventions of whatever nature add to, rather than detract from, the positive impacts of market forces. We also want to ensure they really are justified in terms of the level of risk to our statutory objectives.
>
> 9. Enforcement acts as both a specific and general deterrent – not just to punish the individual wrongdoing but also to send a message to a wider audience to achieve behavioural change in the industry. In deciding on the appropriate regulatory outcome, our approach to firms that consistently behave well and address issues proactively is different to those where we do not see that behaviour. This means, in some cases, a matter might be dealt with entirely by supervisors, but in others, although we investigate we may take no formal disciplinary action or the sanction may be less severe than would otherwise be the case. We see all of these as part of

[25] 'Grudging respect for watchdog as he leaves City fray', *Financial Times*, 9 June 2003

the regulatory dividend for those firms who deal with consumers and us in the right way and act quickly to correct the misconduct.

10. The vast majority of enforcement actions in the last financial year were based on Principles only or a combination of Principles and rules. From 40 disciplinary cases, 12 (30%) were based on Principles and almost all of the remaining cases were a combination of Principles and rules. This demonstrates the alignment of enforcement with the move towards more principles-based regulation. Our Principles have the status of rules and we will continue to take action on the basis of a breach of them. Concerns have been expressed about us relying on a breach of the Principles alone. Our response has been to explain that we cannot use hindsight or apply higher standards retrospectively when deciding whether to take action and that it must be possible for firms reasonably to predict at the time of the relevant conduct whether the conduct would amount to a breach of a Principle.[26]

Its enforcement activity has been thrown into relief with its handling of the split investment trust issue. This issue is covered in depth by another standard note (SN/BT/3769) essentially investors lost a considerable amount of money investing in particular types of investment fund that, although being advertised as being low risk, were, because of their structure and interdependence, highly risky investments. The FSA established an 'informal' rescue fund which provided significant levels of compensation (£195 million) from investment trust companies, for investors who might otherwise have either got nothing or would have had to embark on lengthy court proceedings. The quid pro quo for this settlement was that the FSA would not proceed against the contributing companies. The FSA spent five years investigating the affair, described by John Tiner as "the most serious [he] had seen". In May 2007 the FSA announced that:

The FSA has now resolved and discontinued its investigation in respect of the remaining firms and individuals under investigation:

David Bruce has agreed to resign as CEO of BC Asset Management Limited (BCAM) and to give up his existing controlled functions save for CF27 (investment management). Mr Bruce has also agreed not to perform any significant influence functions until 3 April 2009. The FSA has discontinued its investigation into BCAM.
Roderick Crawford has agreed not to perform any customer functions until 31 December 2007 and not to perform any significant influence functions until 3 October 2009.
Paul Glover has agreed not to perform any customer functions until 3 October 2007 and not to perform any significant influence functions until 3 October 2008.
Anthony Reid, former CEO of BFS Investments Plc (BFS), has agreed not to perform any controlled functions until 3 October 2009. The FSA has discontinued its investigation into BFS which entered into a creditors voluntary liquidation in February 2006.

The FSA has agreed that it will take no disciplinary action against the above firms and individuals. The FSA has not made any findings of regulatory breach against them and the above firms and individuals have not made any admissions.[27]

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[26] Second Enforcement Performance Account http://www.fsa.gov.uk/pubs/annual/ar06_07/enforcement_progress.pdf
[27] FSA press release, 22 May 2007

The general reaction in the press was "Split capital shame"[28] and "Just a cop out from the City's chief bobby"[29] thus adding to the perception that in trying to set a 'light touch' the FSA is not doing enough to deter serious scandals.

The FSA can turn to its record of levying fines and other punishments. A table showing fines issued by the FSA since 2006 is shown below:

Fines imposed by the Financial Services Authority

Year	Company or person fined	Amount £'000s
2006	GLG Hedge Fund	750.0
	Philippe Jabre (of GLG)	750.0
	Capita Financial Administrators	300.0
	Deutsche Bank	6,364.0
	David Maslan (of Deutsche Bank)	350.0
	Royal Liver Insurance	550.0
	Paul Tebbutt	35.0
	Besso Ltd	20.0
	Rainbow Homeloans	35.0
	Foresters Friendly Society	55.0
	Kyte Group	250.0
	Hoodless Brennan	90.0
	Merryl Lynch	150.0
	GLG Partners & Philippe Jabre	750.0
	Braemar Financial Planning	182.0
	Carphone Warehouse	245.0
	Regency Mortgage	65.0
	Berry, Birch & Noble	17.5
	Langtons	63.0
	Loans.co.uk	455.0
	Capital Mortgage Connections	17.5
	Gen Re insurance	1,225.0
	Sean Pignatelli	20.0
	Redcats Brands ltd	270.0
2007	W Deb MVL plc (ING)	560.0
	GE Capital Bank ltd	610.0
	Roberto Cassoni	52.0
	David Whistance	30.0
	Sesame Limited (Sesame)	330.0
	BNP Paribas Private Bank	350.0
	Chartehouse Wealth Management	122.0
	Capital One	175.0
	Nationwide	980.0
	Kilminster Financial Management Limited	42.0

Source: FSA Annual Reports & press releases

[28] Financial Times 23 May 2007
[29] Sunday Telegraph 27 May 2007

It is difficult to say whether the FSA is 'tough enough'. Clearly there is a spectrum of 'toughness' and each point on it will represent trade-offs between regulatory vigour - cost – market efficiency - effectiveness etc.

One of the statutory duties of the FSA is to maintain a competitive market for financial services. As outlined in the NAO report above, the FSA's 'principles' approach has become something of a blueprint for regulators in other countries, not least because London as a City is generally considered to be one of the best places to do business. A report by the City of London Corporation found that London had "extended its lead as Europe's pre-eminent financial centre thanks to comparatively light regulation".[30] Part of this is a comparative thing. There is little doubt that the regulatory reaction in the United States to the problems highlighted by the collapse of Enron and all that followed, is now considered to have been excessive and has actively damaged the financial services industry in the United States.

In a keynote speech prior to his departure in July 2007, the FSA's CEO, John Tiner, reflected on his period of office. The speech is interesting for a number of reasons and is reproduced in full as an appendix to this note. However the points made regarding the balance between tough-light regulation and where the FSA stands are shown below:

> Earlier this year we published an important paper outlining our More Principles Based Approach to Regulation. I passionately believe that this is the right approach – building a regulatory regime which facilitates the ability of markets in the first instance to deal with problems and which incentivises firms to do the right thing in a way which fits their own business model.
>
> As I have said before, I believe a business proposition which pursues a confluence of interest between owners, customers and managers will be successful for the long term and will ultimately reduce the need for regulation. The application of this approach should then be in a risk-based and proportionate way and relevant to the characteristics of the marketplace. This is why, shortly after I became CEO I reorganised the FSA to help us focus a distinct approach on each of the wholesale and retail markets. I believe the various surveys which highlight the growing strength of the London markets bear testament to the benefits that a principles based approach to regulation and a disclosure and eligibility approach to listing can bring. As significantly, I feel the focus on retail has helped us zero in on products and issues which have caused real problems for consumers, such as PPI and Mortgage Exit Fees and we are now tackling the highest of hurdle of all in the retail investment market.
>
> To support this strategy, we have been building an organisation which is relevant to the markets it supervises. We have been improving our internal organisation and infrastructure to enable our staff to focus more on the issues that matter and the real world outcomes of what we do. Although the output of our work cannot be measured in earnings per share as for the firms we regulate, I believe strongly that we should run ourselves like a business – delegated decision making, action orientated, risk taking, investing in people and technology, optimising efficiency.
>
> So the second half has been more fluent. The FSA has enjoyed good ratings by both international and domestic commentators, but I am all too conscious of how things

[30] Reported Financial Times, November 8 2005

> can turn - after all it was only 6 years ago I saw Leeds play in the semi-final of the Champions league and now they're in what I still think of as the 3rd Division. I can assure you the FSA is neither over-confident nor complacent – it is absolutely committed to seeing through the strategy of a More Principles Based Approach to regulation and is investing heavily to achieve that.[31]

He continued by addressing the issue of insider dealing which has been used as evidence of FSA failings. He said:

> We have been the first regulator in a major capital market to research and publish the pattern of share price movements ahead of announcements and to note that over a four year period around a quarter of announcements on the London Stock Exchange had observable material movements in advance. Research by The New York Times suggests the comparable figure in New York is 41%. A similar study carried out by the same firm indicated that last year unusual trading preceded 33 out of 52 larger Canadian takeovers. But there is little or no data in other European or Asian markets. So there can be no suggestion that London is any worse than other markets and may well be better.
>
> These statistics help to put the position in the UK into perspective but in aiming to promote efficient, orderly and fair markets, our concern is to understand what is behind these numbers. Of course some of the movements will be the result of the normal functioning of the market, as investors and speculators take their positions. But it seems likely that inherent in these numbers is the unacceptable practice of trading on inside information.
>
> Over the past few years we have increased the resources dedicated to identifying, investigating and prosecuting market abuse and we have had some important successes. We have committed to our largest investment ever in technology to help us identify patterns of trades between markets and which suggest suspicious behaviour. This will be ready next year. We have focussed increasingly on conflicts of interest between investment banks and their clients, which we will continue to prioritise in our work.
>
> But successfully prosecuting market abuse is not straightforward. The perpetrators may be in a ring designed to disguise the identity of both the intermediaries and the beneficiaries and some may operate from abroad. Market abuse can be a very sophisticated activity where complex derivative transactions which are not easily visible to the market or us may be used. And the standards of evidence to prosecute successfully market abuse are high and reliance on circumstantial evidence can seriously weaken a case. Last year I said that reducing the incidence of market abuse was one of the FSA's three most important priorities. In this area the deterrent effect of enforcement can be considerable and we need all the tools at our disposal to be successful. To help the FSA build a strong case we would like to be granted formal powers to offer immunity in exchange for hard evidence and I would urge the government to accede to this request.[32]

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[31] John Tiner, speech 2 July 2007, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0702_jt.shtml
[32] Ibid

The clearest example of where the FSA is 'getting tough' comes in its treatment of hedge funds. Rules designed to allow hedge funds to remain listed on the less regulated secondary market have been overturned. The working out of competitive regulatory regimes, this time to London's disadvantage compared to Amsterdam is set out in a financial times article – *FSA ditches 'light' hedge fund regime'* – 5 April 2007.

Lastly, it is worth making the point that there has been no major financial crisis or scandal that has emerged entirely under its watch. Endowment mortgages predate it by decades, even the 'splits' had their genesis under the previous regime. The nearest that the FSA has come to having a 'home made' crisis was Equitable Life. However, the Penrose Report did not find the FSA culpable in the collapse of the company.

The Mansion House speech of the FSA's Chairman given on 20 September 2005 sums up how he sees the role and position of the regulator.

> As a broad generalisation, I would say that the wholesale financial services markets are characterised by significant, even fierce, competition, with a range of providers of services competing for the business of for the most part informed and competent potential customers. These happy circumstances allow us to adopt lighter touch regulation where we can rely on the precept of caveat emptor – a principle which has informed our recent statements on the trading of debt instruments; and has enabled us to encourage the industry to develop its own solutions (as we have done with bundled services for asset managers, and are doing for contract certainty in the insurance market), and generally to keep regulatory intervention as a backstop. The position in retail financial services is very different. There is often a disparity between the knowledge and capability of the provider of the retail financial service and of the user of the service such that much less reliance can be placed on the principle of caveat emptor, and there is a correspondingly greater requirement for regulatory intervention in the retail compared to the wholesale market. I should make clear that the FSA's aim is to promote an efficient market for financial services in the retail market just as in the wholesale market – hence our concern to improve financial capability, to promote relevant and understandable information about financial services, and to encourage responsible behaviour on the part of those who provide those services: the behavioural conditions needed to make an efficient market. But until these conditions are met there will be a stronger case for regulatory intervention in the retail than exists in the wholesale market.
>
> That then is my starting point: a financial services sector which is one of Britain's most successful sectors in terms of international competitiveness and profitability; a wholesale market which is for the most part both efficient and competitive, and where regulatory intervention can therefore be – and is – limited; and a retail sector with real obstacles to developing an efficient market, where our regulatory interventions are aimed both at moving towards a more effective market and in the meantime providing in various ways a measure of consumer protection which is much needed.
>
> We are also acutely aware of the costs imposed on the sector by regulation and its consequences for industry and consumers. We know that, to the firms affected, it does not actually much matter where particular regulatory initiatives originate. What matters is the cumulative cost and strain placed on management teams to cope with the aggregate impact.
>
> Where it is within the FSA's discretion to do so, we continue to be concerned to reduce regulation where its existence is not matched by its benefits. Most recently, this has involved our suggestions for removing prescriptive requirements in the areas of individual authorisation, training and competence and anti-money laundering in favour of a more, but not exclusively, principles-based approach. And early next year, our cost of regulation study will enable us to focus on other areas where the costs of the regime may not necessarily be justified by the benefits.
>
> There is a clear shared interest between regulator and regulated in achieving a regime pitched at the right level. We need the help of the industry in defining that level. That's why I have

> challenged the industry to also come forward with views on the areas which could benefit from re examination. I am pleased that the Association of British Insurers, for example, is responding with what promises to be a thoughtful and constructive analysis of how regulation might evolve to the benefit both of the industry and consumers. I hope that this will also examine the role that the industry too must play in delivering a more competitive retail financial services market. I repeat my encouragement for others to take a similarly constructive approach.
>
> Both sides have much to gain from this sort of constructive engagement. We will get better regulation. But there will also be a wider benefit. Too often we overlook the common interests of those who provide financial services and of those who have the task of regulating financial services. Too much of the comment on the relationship between regulator and regulatee represents it as an essentially adversarial relationship. The comment concentrates on enforcement – although enforcement is a small part of the regulatory relationship. The central contention that lies behind much of this comment – that regulation by its nature is and must be bad – is a gross oversimplification. There are enormous advantages, for both practitioners in and customers of markets, for markets having rules – indeed markets cannot exist without rules – it is the rules which define the market. There are great advantages, for both counterparties and customers, in knowing that there are capital requirements which mean that banks, insurance companies and securities firms have adequate capital. In short, there are enormous advantages for all of us in living in a society under the rule of law, and not living a Hobbesian life "nasty, brutish and short".
>
> We as a regulator are conscious of the need for regulation to be confined to actions which the market will not provide itself; and to be confined to actions which are cost effective. We are keen to enlist the industry's help in defining this area better. But we are also keen, as part of these discussions, to encourage a constructive engagement on the reality of regulation which goes beyond what is too often a simplistic adversarial model. We all have much to gain from this. [33]

Although not part of the FSA, no review of the whole system of regulation would be complete without considering too the role of the Financial Ombudsman. The FOS is an effective system of redress, equally as effective as the plethora of organisations it took over from. It is popular with consumers of financial services and, although they complain, cheaper at settling cases for companies than courts would be. The latest FOS Annual Report notes that the 2006/07 financial year saw the FOS deal with its 500,000 case and looked forward to the new responsibilities of dealing with consumer credit cases..

F. Appendix

Speech by John Tiner, Chief Executive Officer, FSA
ABI Annual Conference
2 July 2007

Ladies and Gentlemen I am most grateful to the Chancellor's High Level City Group and to John Varley in particular for organising this opportunity for me to address a few reflections on financial regulation over the last several years and to offer some thoughts for the future.

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[33] Available at FSA website
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0920_cm.shtml

It has been a privilege to lead the FSA these past few years and to serve the customers and firms of the British financial services market. I am conscious that on occasions such as these, there can be a tendency for the speaker to talk about all the things he felt constrained from saying during his period in office and so make life difficult for his successor. Having led the FSA for 4 years that would be neither responsible nor consistent with how I have tried to act - where openness and honesty have always been my by-words. But having had a unique view of both the UK and international financial services industry as its referee, I hope that I can provide some personal perspectives which will stimulate discussion on the one hand but will not upset my Board or my successor on the other. I have learned that the art of good regulation is achieving the right balance between fostering the forces of the market and protecting customers, and I very much hope that my experience at the FSA will enable me to pull off the necessary balancing act in my remarks today.

Perhaps then I could start by looking back at what has happened over my time at the FSA – two years as Managing Director and four as Chief Executive, which by coincidence, and I assure you it is coincidence, almost exactly matches the fall and rise of the equity market.

As the good old football proverb goes, my time at the FSA has been a game of two halves, with quite a bit of extra time played in the second half. Let me explain.

I joined the FSA on 1 June 2001. The FTSE 100 stood at 5800. On 17 June, the firm which the market had rated as the emerging tiger of British insurance and had been voted insurance company of the year over a number of years, Independent Insurance, went bust with the many brokers and analysts who had, for the most part, lauded the new business model of extraordinary growth (but sadly no cash), claiming that they knew all along the business was in trouble.

On 23 July, Equitable Life announced a bombshell to its already worried policyholders of a cut in policy values of 15%. Over the following months, as the FTSE continued to slide, severe problems which had been building up in the Split Capital Investment Trust Market for several years were surfacing and many pensioners who had put their money into High Interest Bonds saw the capital value of their hard earned savings fall off a precipice and in some cases disappear altogether.

Of course on 11 September 2001, the world was shocked, disgusted and numbed by the events in New York. In the distance beyond the human tragedy was a severe test of the resilience of the general insurance market and, because of its prominent position in global markets, of Lloyd's and the London market. And life insurance companies, with well over half of their assets invested in equities, were running out of solvency. With bonuses in the £400 billion with-profits industry falling steadily there were real problems for savers and mortgage endowment policyholders. There were also deeper concerns about the stability of the market as a whole.

By March 2003, the FTSE 100 had fallen to 3287 and hedge funds were laughing all the way to the Cote d'Azur as many had shorted the market in anticipation of the life insurers' sell-off. In the midst of all this, just before Christmas 2001, as the FSA was grappling with all of these and other issues, we were, as you can imagine, delighted to hear Ruth Kelly the then Economic Secretary, announce in the House of Commons that the FSA would be asked to regulate all general insurance and mortgage intermediaries – increasing our coverage from some 9,000 to 25,000 firms. And the FSA had only become operational under the Financial Services and Markets Act on 1 December 2001.

Hence this was a period of extraordinarily intense activity dealing with what we call in regulatory jargon "crystallised risk". At the same time, however, we urgently needed to reform our regulation of the insurance markets by introducing modern techniques of

financial economics and risk management into the opaque world of life insurance in particular and prepare for the influx of firms to the world of regulation as diverse as vets which promote pet insurance, to the largest insurance brokers in the world.

Having spent 25 years in the private sector prior to my arrival at the FSA, I was conscious that as a regulator one should not and cannot set out to please everyone all the time (occasional unpopularity is a prominent part of the job description). But it is probably fair to say that I had not anticipated the weight of conflicting opinions on so many issues, so early on. Our job is to think about the arguments in the context of the best outcomes consistent with our Statutory Objectives – and during these first years of the FSA's life, balancing the maintenance of market confidence with the appropriate protection of consumers was constantly in the forefront of our thinking. And an additional problem is that often we are not able to fully explain decisions we take. I believe the outcomes from the challenges we faced in those early years have been satisfactory, including:

- The life insurance industry was stabilized and the heat was taken off the falling FTSE, by what at the time seemed a brave decision by the FSA's to assess a companies balance sheet with reference to realistic values rather than some opaque historical method;
- Mortgage Endowment policyholders have been compensated to the tune of some £2 billion; and
- Investors in Zero Dividend Preference Shares, the worst affected by the problems in the Split Cap market, have received almost £200 million from the largest fund ever created on a voluntary basis in the UK financial services industry. Due to a multitude of legal complexities, the payouts to investors were certainly years earlier and quite possibly of a larger sum than would have been paid out as compensation had we concluded successful enforcement cases in the Tribunal.

Like watching the first 45 minutes of my beloved Leeds United, the first half of the FSA's life was one of attrition, but with the scoreline still intact. And yet commentators who follow the FSA continue to place its progress as a regulator since its formation in 2001, in the context of benign markets – perhaps this is illustrative of the short memory which inflicts some in the financial services market and which may spell some dangers for the future as markets become much tougher. It is true that the credit markets have been benign for many years but, as I have tried to illustrate, the investment markets have been anything but.

The last 4 years have witnessed sustained growth in all major asset classes and the correlations between them have been rising. Of course these market conditions and correlations have been great news for investors across the board, but wearing the mantle of a (rightly) sceptical regulator, one obvious question I worry about is what will happen when conditions become tough. As they have moved up together, will they go down together – personally, I doubt it as tighter liquidity will create different price developments in different markets and correlations will break apart - but how and with what impact? And if we face really difficult conditions in the credit market, will there be enough wise and experienced heads from the last severe downturn to take control of the situation? There are an awful lot of brilliant young people in the credit market who have not faced such times before.

The lessons of earlier periods tell us that problems which surface in falling markets are created by exuberance in strong markets and so we have been particularly vigilant these past 4 years to identify products and trends which when faced with stressed market conditions will not perform as consumers had been led to expect. However, the broadly based benign market conditions have given us the breathing space to develop our

strategy and our capability for delivering this strategy. This was the essence of the half time talk in September 2003, between the new club chairman, Callum McCarthy and the recently elevated manager, John Tiner.

In taking the field for the second half we were both clear in our belief that the core of our regulatory strategy should be to harness the forces of the market to deliver the results set for us by Parliament – and to utilise the yellow and red cards when the players committed serious fouls. But we wanted to let the game flow. By its very nature regulation is the grist in the mill of a free market place. With rare exceptions it is markets which are the fuel of economic growth, competitive activity and product, distribution and service innovation. If regulation is to contribute positively to the outcomes free markets produce, its application must be very carefully and cautiously considered with all other avenues explored and rejected first. If strict disciplines are not followed by regulators, unjustified costs will be loaded not just on the firms or entities which are directly subject to regulation but on consumers and society more broadly.

Markets thrive on competition and in its regulation the FSA has a responsibility to have regard to competition. I must confess that I would favour the FSA having a fifth statutory objective to promote competition. This would be entirely consistent with our strategy of working with the grain of the market and delivering fair outcomes for consumers. It might simplify the regulatory structure for many firms as the FSA would have a different kind of relationship with the OFT and it would join-up responsibilities for unfair contracts. For the avoidance of doubt, I would see this as a responsibility to create better, cleaner, fairer markets and not to promote the attractiveness of London as a financial centre. We will do our bit for that agenda if we regulate sensibly and effectively and we should leave others to do the marketing.

Earlier this year we published an important paper outlining our More Principles Based Approach to Regulation. I passionately believe that this is the right approach – building a regulatory regime which facilitates the ability of markets in the first instance to deal with problems and which incentivises firms to do the right thing in a way which fits their own business model.

As I have said before, I believe a business proposition which pursues a confluence of interest between owners, customers and managers will be successful for the long term and will ultimately reduce the need for regulation. The application of this approach should then be in a risk-based and proportionate way and relevant to the characteristics of the marketplace. This is why, shortly after I became CEO I reorganised the FSA to help us focus a distinct approach on each of the wholesale and retail markets. I believe the various surveys which highlight the growing strength of the London markets bear testament to the benefits that a principles based approach to regulation and a disclosure and eligibility approach to listing can bring. As significantly, I feel the focus on retail has helped us zero in on products and issues which have caused real problems for consumers, such as PPI and Mortgage Exit Fees and we are now tackling the highest of hurdle of all in the retail investment market.

To support this strategy, we have been building an organisation which is relevant to the markets it supervises. We have been improving our internal organisation and infrastructure to enable our staff to focus more on the issues that matter and the real world outcomes of what we do. Although the output of our work cannot be measured in earnings per share as for the firms we regulate, I believe strongly that we should run ourselves like a business – delegated decision making, action orientated, risk taking, investing in people and technology, optimising efficiency.

So the second half has been more fluent. The FSA has enjoyed good ratings by both international and domestic commentators, but I am all too conscious of how things can turn - after all it was only 6 years ago I saw Leeds play in the semi-final of the

Champions league and now they're in what I still think of as the 3rd Division. I can assure you the FSA is neither over-confident nor complacent – it is absolutely committed to seeing through the strategy of a More Principles Based Approach to regulation and is investing heavily to achieve that.

Now to look to the future. I leave on my desk a large in-tray of outstanding work for my successor. It will be for him or her, together with the Board, to decide how to bring the outstanding matters to a close; although some of the items will be well above their pay grade: at the Government and European level. I would like to say a word or two about five of the dossiers – to borrow a term from our continental colleagues: (1) regulation of the largest EU financial institutions; (2) the shape of the retail market for investment products and services; (3) financial capability; (4) banking regulation; and, (5) market abuse. These are all complex and evolving issues and I do not claim to have the answers – if it were that easy I would have dealt with them by now – but I hope that raising them today will contribute to the debate - as I think they are vitally important matters for our economy, society and financial markets.

Firstly, how should the major financial institutions of Europe be regulated? In my view, policymakers and regulators at the EU level should challenge themselves to pull-off the three card trick of:

i. facilitating the largest financial institutions to become stronger European institutions and more competitive globally;

ii. enabling smaller firms to compete fairly alongside these major players in domestic markets and so increase diversity and choice; and

iii. maintaining financial stability and protection of European consumers.

I want to focus particularly on the first of these. In my mind the regulatory structure in Europe is overly complex and burdensome for major firms – the Champions League equivalents, if you like - who operate across the European Union and who compete in global markets.

The current picture is mixed. A firm which branches across Europe will have a single prudential regulator in its home country and the conduct of business responsibilities will vary depending on the sector in which the firm operates (i.e. conduct of business may be country-specific). On the other hand, groups which operate through subsidiaries will have to maintain adequate capital in each and every legal entity and comply with the particular prudential and conduct of business requirements in each country of operation.

The political ambition outlined in the Lisbon agenda, was to make European markets more competitive which in turn would stimulate economic growth and a wider choice for consumers. It must be wrong that in a single market decisions on corporate structure, location of capital and modus operandi (that's the only piece of Latin in this speech) should turn more on regulatory considerations than on business needs. Yet we have a situation today where large groups change their structure and domicile often not to better serve their customers or their shareholders but to get a regulatory outcome they want. Of course, there will always be some kind of regulatory or other arbitrage between jurisdictions on a global basis – and this is not a bad thing if its effect is to bring regulatory standards towards an equilibrium - but it should not exist within a single market. Coupled with duplication of demands from regulators across the EU, this hampers European firms from competing in the global markets.

I have heard that the idea of a single EU regulator for the largest firms is gaining currency among both the major firms themselves and the political establishment. I should say very clearly that I do not think this is the answer. Apart from questions of cost, location, regulatory style and so on, there will be intractable negotiations about

whether there should be an integrated regulator like the FSA or sector based regulators as they have in France, Spain, Italy and some other member states. There is no agreement on whether that approach should be risk-based; or whether the regulatory organisations should combine prudential and COB responsibilities. I believe that Europe must be pragmatic in promoting the growth of the single market and fostering the competitiveness of our major companies and should not become distracted by theoretical, bureaucratic and perhaps partisan discussions about the institutional framework.

To me the answer lies in the intelligent – not simplistic – adoption of the so called "Hard Lead Regulator" approach. In December last year the Treasury and the FSA (in a joint discussion paper on group supervision for the purposes of Solvency 2) proposed that prudential supervision of a group should be the responsibility of the home supervisor. So, for example, risk-based capital would be considered only at a consolidated level, with only minimum levels of capital required to be held in subsidiaries. Legally enforceable mechanisms would need to be put into place requiring parent companies to maintain the minimum capital in subsidiaries. I think of a parallel in the world of auditing, where group auditors send instructions to their offices to do specific work at a local level on material branches and subsidiaries. The home supervisor could similarly instruct host supervisors to assist for example with Pillar 1 capital assessments and the judgements required under Pillar 2. Ultimately, the home supervisor would take responsibility.

I could see this concept applying to European financial conglomerates, insurance groups, banking groups and securities groups. Of course such a system would require regulators to work closer together at an operational level and for the legal system to be robust.

Alongside this approach the Lamfalussy Committees would continue, but their priorities would shift from providing technical advice to the Commission on new laws (which I hope very much will be significantly curtailed in the future), to aligning regulatory approaches and practices at a day to day level. I think the benefits would include more efficient allocation and therefore lower costs of capital for business, less regulatory duplication and so lower costs, more competition and ultimately a better environment for maintaining financial stability and protecting consumers.

The approach we have introduced of holding regulatory colleges to discuss large groups is already helping to co-ordinate regulation and is the kind of platform that the EU should build on.

Every proposal to address this important issue has its challenges and I see three which would need to be overcome. First, there would need to be consideration of special powers being granted to countries where institutions which are systemically important to that particular country but are not material to the group whose parent is located in another member state. Second, compensation systems in the event of failures would need to be better aligned. Third, provisions would need to be introduced for host supervisors to be able to deal with liquidity crises in their domestic banking sector

As a final point on Europe, I would urge the Commission to step back from the patchwork quilt of conduct of business regulations and the mess over home/host responsibilities and seek a coherent solution which firms and, most importantly consumers, will be able to understand.

Moving from the international to the domestic arena, last week the FSA published a discussion paper on the retail market for investment products and services. This sets out the ideas of the industry/consumer/FSA working groups to address the problems of the retail investment market which were so clearly diagnosed by Callum McCarthy last year and which seem to have resonated with many stakeholders. I don't want to repeat the

comments of my colleagues who have been talking about this paper during the last few days, but would like to emphasise two points of my own:

- Whilst I do not believe in theory that advisers or intermediaries who are remunerated by commission based on volume of sales are necessarily biased in their recommendations, the practical effect of the incentive structures in the supply chain has all too often been to operate against the interests of the customer. I very much hope the FSA will have the fortitude to follow through the proposition that the cost of the product and the cost of the service should be clearly separated and negotiated and that the term "Independent Financial Adviser" should only be used by those who select from the whole of market and are remunerated by fee. On reflection, I wish we had stuck to our guns in 2002, when we made a similar proposal in the infamous CP121 on depolarisation.
- To my mind the biggest prize from the review will come from a successful debate about how to improve supply to and access by the mass market. There are some big questions here, the answers to which will require all parties to be bold and take some risks:

  - Firstly, is there an economic equation which will bring the major financial brand names to increase supply substantially? This will need to involve lower regulatory and other cost of sales, much lower ongoing regulatory risk, a competitive market for charging levels and sufficient average levels of investment to generate adequate returns on capital employed. It will remain a feature of investment markets for sometime that products are sold and not bought, and stimulating supply is the critical element in unlocking the mass market.
  - Secondly, can the above be achieved in a more principles based regulatory environment because firms have operationalised the principle of Treating Customers Fairly? Or, in order to lower regulatory costs and regulatory risks, is it necessary for there to be tightly defined product specifications and risk parameters which would fly in the face of the FSA's market-orientated, principles-based approach?
  - Will consumers flock to the market in response to increased accessibility, marketing, advertising, etc based on higher levels of financial capability or will they remain on the sidelines until there has been a simplification of the tax and benefits system?

I, like many of our stakeholders, feel that the climate into which the Retail Distribution Review is being launched offers as good an opportunity as any time in the last 20 years to realise a market which will work for both firms and consumers. Government, regulators, ombudsmen, firms and consumers must step up to the plate if this is to be successful.

My third point has been one of the main areas of focus for the FSA over the last four years. Since I launched the FSA's national strategy for financial capability in 2004, I have been extremely pleased with the progress made in schools, the workplace, colleges of further education, universities and in many voluntary and community organisations across the country to help people become more financially able and confident.

I am delighted that the FSA board has backed a programme to spend £60 million over the next three years. Financial Capability is now firmly on the public policy agenda and under the leadership of Ed Balls in his last position as Economic Secretary, the Government has put cross-departmental weight behind financial capability.

To create a more self standing society in the future, young people will need basic levels of financial competence as they make key money decisions earlier in their lives and I would hope that Ed, in his new role as Secretary of State for Children, Schools and Families, will be able to ask his new colleagues to find room for financial education on the mandatory core curriculum at the earliest opportunity.

Otto Thoresen of Aegon is currently leading a study for the government of generic advice. I feel generic money advice is a key missing component in helping people become financially included and making the right choices about their money. It remains to be seen whether Otto will be able to construct a persuasive business case for the private sector to fund a generic money advice service, perhaps in partnership with Government. Others have been through this loop and have been unable to unlock the business case.

I do not think the FSA should be given the specific responsibility to build and operate a generic advice service funded through its annual levy. This could certainly put the FSA into a compromised position and in any case it is not set up to run or oversee a national operation of that kind. Generic advice needs to leverage off what has already been done through the FSA's National Strategy, existing and trusted routes to target consumers should be harnessed and a new superstructure should be avoided at all costs. But even with highly devolved delivery channels, there will be a need for centralised governance, oversight, support and content management. This will provide the Government with an opportunity to plan for the next stage in growing the financial capability of the British population.

The FSA will have a key long term role to play as its brand is respected by intermediary organisations, trusted by consumers for being independent and raising the financial capability is central to its strategy towards the retail market. I would encourage the Government to look creatively at this issue. I think there is good sense in consolidating the financial capability agenda with generic advice, perhaps under a new body dedicated to this work and which somehow sits within the auspices of the FSA.

Of course I realise that I throw this idea out having not heard Otto's conclusions and with many unanswered questions related to funding, accountability, etc. But there is a real chance to make a difference and to scale-up this critical work for society and I just urge all decision makers not to pass up the opportunity.

As I mentioned earlier, the scope of activities the FSA regulates has increased markedly during my 6 years. Only last week we [I shall have to stop saying that very soon] were handed responsibility for travel insurance sold by travel agencies, which may bring up to a further 3200 firms into the FSA net.

I strongly agree with the sentiment of Callum's statements in successive annual reports, business plans and speeches, that the FSA should not be a skip for all things regulatory which touch on financial services because it risks diluting our focus and damaging our operational capability.

I think it would be helpful if a model were to be defined setting out the public policy rationale for what the FSA is required to do. I can see, for example that it makes eminent sense, as Mervyn King outlined at the Mansion House, for the major payment systems to be regulated by the FSA – a proposal which we have supported.

Earlier this year I told the House of Lords Committee on Regulation in March that I thought further consideration should be given to consolidating regulation of the banking industry and I would offer a couple of specific ideas in this area.

I understand that in the run up to the introduction of FSMA, following consultation, the FSA decided not to "switch on" its principles or exercise powers to make rules relating to the conduct of deposit taking business. Perhaps surprisingly to the outside world, therefore, retail banks do not have a regulatory obligation to treat their customers fairly, other than in respect of complaints. The FSA said in its submission to the review of the Banking Code that a fairness provision should in future be included in the code. I wonder, on reflection, whether in fact the conduct of banks should be brought solely under the umbrella of the FSA so falling into its principles and risk-based approach and with enforcement powers to utilise when warranted. This way, the regulatory gaps I have referred to would be eliminated, the regulatory landscape would be simplified with one less regulator and the FSA as the UK's integrated regulator for financial services would have a much better overall picture of the UK banking market.

Perhaps more controversially, I wonder whether the regulation of the consumer credit activities of the banks, building societies and other firms already authorised by the FSA would not be better located in the FSA.

The growth in consumer credit is well documented and risks related to credit have jumped up the household agenda, with concerns about opaque charges, over-borrowing and affordability. Yet the regulatory framework is disjointed – with first charge mortgages coming under FSA's risk-based regime but other types of credit subject to more of a licensing approach. I am certainly not saying that credit should be subject to the full rigours of FSMA, nor am I advocating all 126,000 companies with a consumer credit licence be regulated by the FSA. For the many other very small firms, it might be worth reviewing the benefits of regulation at all. But there are risks to consumers which I believe could be better dealt with through a more coherent and risk-based regulatory framework, which would also make more sense for the main lenders to only have to deal with one regulator and one set of regulations.

There is not time today to develop all the arguments or to analyse in detail the pitfalls and problems and I recognise there are real complexities about the potential legal framework and maintaining a level playing field.

The final area I would like to touch on is market conduct. During the last several years London has strengthened its position in the world's capital markets. The UK now has leading positions in international equity and bond offerings, derivative markets and structured products such as securitisations. Market participants have become more diverse and active – as hedge funds and private equity houses have joined longer term institutional investors and private investors as owners of businesses.

As a by product of all this increased activity, corporate announcements which impact on share prices have risen. There are more advisers, longer lists of firms and individuals who have knowledge of impending announcements (so-called insider lists) – we have seen one with a list of 1,500 people. Then we have the old grey area of what is a genuine market rumour and what is a planted story designed to move a share price. And international participation in our markets has continued to strengthen. The heightened level of activity has fuelled the growth of the City and the contribution of financial services to the British economy. This all sounds pretty positive and indeed is for the most part. Of course my concern centres on questions of market abuse and insider trading in particular.

We have been the first regulator in a major capital market to research and publish the pattern of share price movements ahead of announcements and to note that over a four year period around a quarter of announcements on the London Stock Exchange had observable material movements in advance. Research by The New York Times suggests the comparable figure in New York is 41%. A similar study carried out by the same firm indicated that last year unusual trading preceded 33 out of 52 larger Canadian

takeovers. But there is little or no data in other European or Asian markets. So there can be no suggestion that London is any worse than other markets and may well be better.

These statistics help to put the position in the UK into perspective but in aiming to promote efficient, orderly and fair markets, our concern is to understand what is behind these numbers. Of course some of the movements will be the result of the normal functioning of the market, as investors and speculators take their positions. But it seems likely that inherent in these numbers is the unacceptable practice of trading on inside information.

Over the past few years we have increased the resources dedicated to identifying, investigating and prosecuting market abuse and we have had some important successes. We have committed to our largest investment ever in technology to help us identify patterns of trades between markets and which suggest suspicious behaviour. This will be ready next year. We have focussed increasingly on conflicts of interest between investment banks and their clients, which we will continue to prioritise in our work.

But successfully prosecuting market abuse is not straightforward. The perpetrators may be in a ring designed to disguise the identity of both the intermediaries and the beneficiaries and some may operate from abroad. Market abuse can be a very sophisticated activity where complex derivative transactions which are not easily visible to the market or us may be used. And the standards of evidence to prosecute successfully market abuse are high and reliance on circumstantial evidence can seriously weaken a case. Last year I said that reducing the incidence of market abuse was one of the FSA's three most important priorities. In this area the deterrent effect of enforcement can be considerable and we need all the tools at our disposal to be successful. To help the FSA build a strong case we would like to be granted formal powers to offer immunity in exchange for hard evidence and I would urge the government to accede to this request.

I am sorry I have reflected for rather too long this afternoon. Perhaps this itself reflects the huge breadth and depth of our responsibilities. Can I close by thanking all of you for being professional, challenging and for the most part courteous counterparts during the last several years. For someone who cares passionately about the financial services industry and its contribution to the economy and society, I cannot imagine a better job than being CEO of the FSA. And so it just leaves me to wish my successor (whoever that may be) every success and good fortune for the future. Thank you.