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Financial Services Regulation – The Reform of the English System

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> *Financial systems are changing substantially and to an extent that undermines traditional approaches to regulation and, most especially, the balance between rules, incentives, and market discipline. In particular, globalisation, the emergence of a more unified European capital market, the pace of financial innovation and the creation of new financial instruments…all create a fundamentally new environment in which regulation and supervision are undertaken.*[1]

Following the law reforms at the turn of the new millennium, the law relating to regulation of the UK financial markets is now contained in a single statutory instrument, The Financial Services & Markets Act 2000 ("FSAMA"). What began as a Labour government initiative to "reform and strengthen the regulatory system,"[2] escalated and expanded into the creation of one of the industry's most powerful regulatory bodies and contemporary regulatory systems. The Financial Services and Markets Act is said to have "overhauled and unified"[3] regulation of the UK financial sector.

On 1st December 2001 the FSAMA replaced not only the Financial Services Act 1986 but also the Insurance Companies Act 1982 and the Banking Act 1987. The FSAMA has consolidated and substantially replaced the law on financial service regulation; however while it is said that the law is now consolidated in a single statutory instrument, this is not strictly true, along side the FSAMA there exists a vast sum of secondary legislation that expands and implements the Act.[4] In reality, although the FSAMA is a substantial

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[1] Llewellyn, D.T. (2000) Financial Regulation: A perspective from the United Kingdom. *Journal of Financial Services Research,* Vol. 17(1) pp. 309-317

[2] Per Gordon Brown IN: HM Treasury. (1997) *The Chancellor's Statement to the House of Commons on the Bank of England and Financial Regulation*. Available from: http://www.hm-Treasury.gov.uk/newsroom_and_speeches/press/1997/press_49_97.cfm

[3] Blair, M (2001), *Blackstone's Guide to the Financial Services & Markets Act 2000*. Oxford, Oxford University Press.

[4] To date there is an estimated 200 pieces of secondary legislation in operation under the FSAMA.

document it provides only a framework of the regulatory law, the key sources of substantive law are Treasury Orders and the FSA Handbook.[5]

This work provides an analysis of UK financial market regulation under the FSAMA. It begins by introducing the single regulatory authority, the FSA, it's functions, powers and objectives and the system of accountability that surrounds it. The paper then continues by explaining the framework of the new law and details of where further information can be found, be it in the FSA Handbook, the FSAMA or one of its many pieces of secondary legislation. Due to the sheer size of the Act this paper doesn't afford time to an in-depth examination of all of its some 400 sections; after all is that not precisely the job of Parliament and indeed the new regulator?

What the work does do is to familiarise the reader with the essential and fundamental elements of the new system before embarking on brief discussion and consideration of topical issues surrounding the Act. The paper provides a critique of the original, and indeed continuing, rationale for the introduction of the FSAMA, they're legitimacy and whether the Act has achieved all that was intended.

A. AN OVERVIEW OF THE FINANCIAL SERVICES & MARKETS ACT 2000

1. The Financial Services Authority

The Financial Services Authority ("FSA"), the single statutory body in charge of regulating and supervising the UK financial services sector, is at the heart of the new regime. The principle of self-regulation that formerly operated in the UK markets has been dispensed with in favour of one of the most powerful regulators of any financial services market. The Authority has

[5] The FSA Handbook of Rules and Guidance is located online at: http://www.fsa.gov.uk/vhb/

assumed the responsibilities of no less than nine former regulators[6] and has been described by some as a "super-regulator."[7] At the same time the FSA has also taken over the role as the UK Listing Authority from the Stock Exchange. In addition, the FSA is soon to become the regulator of mortgage lending[8] and in 2005 it will become the general insurance regulator.[9] The FSA now has power under the Unfair Terms in Consumer Contracts Act, regulates Lloyd's Insurance market, and has taken over from the Treasury in dealing with Recognised Overseas Investment Exchanges. This very brief summary gives the reader some idea of the immense range and scope of the FSA's powers.[10]

a. Legal Status

This new 'super-regulator is an independent, non-governmental body. It is a company limited by guarantee and is financed through fees payable by regulated intermediaries. As a consequence of its limited liability status, members of the Board cannot be held personally liable for any charges against the FSA. One of the reasons behind the status of the FSA is the idea that by having the regulator as a non-governmental body, it "remains rooted in the financial markets and consequently is more alert to industry concerns." An alternative reason is that the FSA is simply the former regulator, the SIB, renamed. By having the private body status it meant that the effective merging of regulators when introducing the new regime was made far simpler.

The FSA enjoys immunity from civil actions and cannot be liable in damages, unless it is deemed to have acted in bad faith or in breach of the

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[6] Namely, the Bank of England Supervision & Surveillance Division, Insurance Directorate of DTI, Lloyd's of London, Building Societies Commission, Friendly Societies Commission, Register of Friendly Societies, Securities & Futures Authority, Personal Investment Authority and the Investment Management Regulatory Organisation.

[7] http://news.bbc.co.uk/1/hi/uk_politics/778525.stm

[8] The FSA will become the mortgage regulator from the second quarter of 2004. The FSA will not however become responsible for regulating general lending arrangements. These will continue to be regulated by the Consumer Credit Act 1974 and the Office of Fair Trading.

[9] At this point in time general insurance is still regulated by the General Insurance Council, occupational pensions are regulated by the Occupational Pensions Regulatory Authority and consumer credit is regulated by the Office of Fair Trading.

[10] See sections A.9 and A.11 for details on specific powers of the FSA.

Human Rights Act 1998.[11] However the FSA can be "held accountable under the tort of misfeasance of public offence"[12] as was the case with the Bank of England following the BCCI collapse.[13]

b. The Board

What little information the FSAMA contains on the constitution of the FSA can be found in Schedule 1 of the Act. The FSA is governed by a Board of executive and non-executive members. The decision to appoint a board rather than a single Director General was taken in light of the extensive powers of the FSA. To entrust the responsibility for such vast powers on a single person could be highly dangerous, especially given that the FSA is a private limited company. The Board is composed of 11 non-executive members,[14] a chief executive, a chairman[15] and 3 managing directors. The structure, which can be seen in Appendix 2, is said to allow for greater transparency and accountability.

The role of the board is to oversee the exercise of power by the FSA and to deal with issues of corporate governance. A minimum of five votes is required for any cause of action to proceed. The non-executive members have the role of overseeing the efficiency and internal controls of the FSA and are also responsible for setting the remuneration of the chairman and executive members.[16]

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[11] FSAMA 2000, Schedule 1 Part IV s. 19

[12] Misfeasance is the term used to describe the act of improperly doing something that one has a legal right to do.

Mistry, H.B. (2001) The Loss of Direct Parliamentary Control. Does this Mean a Financial Services Regulator Without Accountability. *Company Lawyer*. Vol 22(8), pp. 246-248.

[13] The case of BCCI Liquidators v. Bank of England began on

[14] FSAMA 2000, Schedule 1, s. 3(1)(a)

Of the 11 non-executive members, one is appointed as Deputy-Chairman also known as 'Lead Non-Executive.'

[15] The roles of Chief Executive and Chairman were previously combined but in 2003 a decision was made to separate the roles to ensure there was no possibility of a conflict of interest or other potential problems arising.

[16] FSAMA 2000, Schedule 1 para. 4(3)(b)-(c)

The Treasury is in charge of appointing and dismissing the executive board, the chief executive and the chairman, with the FSA appointing the non-executive members.[17] The FSAMA contains no formal requirements of appointment and dismissal of members of the board, except that they must not be members of Parliament or the Northern Ireland Assembly. There is no fixed term of office for the FSA chairman and the Act makes no mention of reappointment issues or the duration of a member's appointment. Appointments will however be governed by principles for public appointments issued by the Commissioner for Public Appointments, 'the Nolan Principles':

- Selflessness
- Integrity
- Objectivity
- Accountability
- Openness
- Honesty
- Leadership

This includes public advertisement of vacancies and the recent recruitment for a new chairman was advertised in national newspapers and on the Treasury's website.

c. Functions & Objectives

The FSA's general functions are:

- Making rules under the FSAMA
- Preparing and issuing codes
- Giving general guidance
- Determining general policy and principles.

In conducting these functions the FSA has a duty to act in a way which is compatible with the statutory objectives introduced by Section 2 FSAMA and forming the foundation of financial regulation by the FSA:

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[17] FSAMA 2000, Schedule 1 para. 3(2)

- The Maintenance of Market Confidence - Requiring that the FSA maintain confidence in financial markets and exchanges and regulated activities conducted in the UK.
- Promotion of Public Awareness - refers to public understanding of financial systems; including both the risks and benefits.
- Consumer Protection – Requiring the FSA to secure an appropriate degree of protection for consumers. However, consumers must not assume that they can act without responsibility for themselves; the FSAMA maintains that consumers are ultimately responsible for their own actions.[18]
- Reducing Financial Crime – Requires the FSA to reduce the extent to which is it possible for a business to be used for the purpose of committing financial crimes.

The Economic Secretary stated that a trade-off would have to be made by the FSA as between its objectives; the FSA will have to strike a balance both between different objectives and also the requirement to have regard to the desirability of competition. The FSA should not view any one of its objectives as more important than another; consequently it should remain an impartial regulator whose ultimate aim is to do the best by all concerned.

In pursing its objectives, the FSA must have regard to the seven 'principles of good regulation' also listed in Section 2. These are:

- Efficient and economic use of its resources.
- The responsibility of those managing authorised persons.[19]
- Proportionality of restrictions.
- Facilitation of innovation.
- The international nature of financial markets.
- Minimising adverse consequences.

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[18] FSAMA 2000, s. 5(2)

[19] The meaning of this principle is that the FSA should keep in mind that the internal management of authorised bodies must remain responsible for the conduct and behaviour of the body. The management cannot abandon their responsibility even where market regulation is in force.

- Facilitation of competition between regulated bodies.
- The FSA is also required to follow "principles of good corporate governance."[20]

The exact legal status of the principles and more importantly the objectives is not known,[21] however what we can be sure of is that the principles provide a positive means by which the FSA is guided in accomplishing its objectives. Without them it would be far simpler for the FSA to 'go off track' or use inappropriate methods of regulation. In taking this approach the Act has made clear the valuable features of the UK market without unduly confining the FSA's choice of approach.

In addition to the main objectives, the FSAMA sets out four general functions of the FSA. These are, rule making under the FSAMA, preparing and issuing codes, giving general guidance and determining general policy and principles.[22] The scope of the FSA's powers will become more apparent when further sections of the Act are discussed.

2. Accountability of the FSA

Accountability of the FSA is a major issue due to the sheer size and scope of its powers. The government has sought to supervise these powers through numerous modes of accountability. The FSAMA has attempted to achieve a balance in the FSA between a sufficient level of accountability and the independence which is necessary for effective regulation. The Treasury is the key body in ensuring accountability of the regulator, with little if any direct mechanisms of Parliamentary accountability.

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[20] FSAMA 2000, s. 7

[21] It may be useful to consider statements made by both the Joint Committee and a leading author on the legal status of the principles. The Joint Committee in its First Report stated, "[the principles] should apply at the level of general policy…rather than applying directly to every single act and decision of the FSA." First Report, para. 24. Alcock (2000) has also suggested that it is unlikely that the principles and objectives can be used to challenge any specific decisions of the FSA. Although neither of these gives us a definitive answer, they suggest that the principles are not per se legally binding.

[22] FSAMA 2000, s. 2(4)

More can be found on the duties of the FSA in the section headed "The Respective Roles of the Regulatory Bodies."

As mentioned above, the Treasury has the power to appoint and dismiss members of the FSA Board.[23] This is a very strong power as the FSAMA makes little mentions of other rules in this area. In addition the Board must provide an annual report for the Treasury on the achievement of their statutory objectives, accompanied by a report from the non-executive members of the Board. These reports are later laid before Parliament. The FSA is then required to hold an annual general meeting within 3 months of the report. This can be attended by any interested parties and is similar to annual shareholder meetings that must be held by all companies.

Members of the Board may also be called to give evidence before the Treasury Select Committee as a further measure to check their performance. [24] The Treasury has a further power to commission reviews and enquiries into FSA actions and decisions. Awareness that such a power exists is likely to encourage good behaviour by itself.

The FSAMA provides for both a Consumer and Practitioner Panel who are there to advise the FSA on relevant issues, and a Regulatory Decisions Committee who report directly to the board. Members are appointed by the FSA but the Treasury's approval is required for appointment of the chairman. The FSA is obliged to have regard to any presentations made by these panels. It is not under a duty to follow their recommendations but where the FSA diverts from them it must justify its decision to do so.

Further external scrutiny is provided for via the Competition Commission and the Office of Fair Trading. All FSA actions are subject to review for their impact on competition in financial markets.

The FSAMA also provides for accountability measures through the FSA itself. The statutory objectives and principles of good regulation outlined in the preceding section not only improve the discharge of regulation but they also provide an indispensable basis for accountability of the FSA. Its achievements, which are assessed in the annual report to the Treasury, can be evaluated in relation to the fulfilment of its objectives. The FSA must hold annual general meetings within three months of reporting to the Treasury and

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[23] See above, A.1.b The Board.

[24] A committee established with the power to undertake reviews, take evidence and issue reports.

it is required to consider representations made to it by the Consumer & Practitioner Panels.[25]

Finally, the FSA can be liable for the tort of misfeasance[26] and it is amenable to judicial review.[27] The FSA can be made to account through the process of judicial review; a review by the administrative courts of the way in which an FSA decision has been made.[28] This is not to be confused with an appeal against the decision itself, which would be conducted by the Financial Services Tribunal.[29] An application for judicial review should be made directly to the court. Thus far there has only been one application for *permission to apply*[30] for judicial review of an FSA decision and this was rejected by the Administrative Court and again by the Court of Appeal.[31]

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[25] FSAMA 2000, s.11

[26] Ibid, n.12

The case of BCCI Liquidators v. Bank of England, which is currently in progress, serves as an illustration of the complexity of succeeding with such allegations. As a general rule, the House of Lords intends that the FSA to conduct its activities with minimal interference from the courts.

[27] Under the former system the SROs were also amenable to judicial review, this is not a new development.

[28] The process of judicial review is only open where the function of the body is public. It is not an appeal of a decision that has been made but more a review of the *way* in which the decision was made, the decision making process.

[29] The Financial Services Tribunal is an independent body from the FSA; it is within the Lord Chancellor's Department.

[30] An applicant must obtain permission to apply for judicial review before any decision on whether to undertake the review is taken by the courts.

[31] R (Davies & Others) v Financial Services Authority [2002] EWHC 2997, [2003] 1WLR 1284, [2003] 1 All ER 859. The case involved an application for judicial review of an FSA decision to issue warning notices to the applicant under s.57 FSAMA. Both the Administrative Court and the Court of Appeal held that the applicant's grounds were unarguable, and his application was refused.

Although judicial review is in theory open to aggrieved people, the courts have demonstrated a keen reluctance to interfere with decisions made by regulatory authorities. The decision in R v SFA ex p Panton, June 20 1994, is a clear display of this intention; Sir Thomas Bingham stated that, "These bodies are amenable to judicial review but are, in anything other than clear circumstances, to be left to get on with it." Hence we are likely to find that judicial review will seldom be available, nonetheless it does still provide a tool for holding the FSA to account.

3. Regulated Activities & The General Prohibition

In accordance with European Directive requirements,[32] Section 19 FSAMA provides for the "general prohibition" on providing regulated financial services; anyone other than an *authorised* or *exempt* person is prohibited from carrying on any regulated activity within the UK.[33] Contravention of the general prohibition constitutes an offence under the Act and the offender can be liable to imprisonment for up to 6 months and a monetary fine.[34] In addition, any agreements made in contravention of the general prohibition are unenforceable,[35] although the court does retain a discretion to allow an agreement to be enforced where it would be 'just and equitable' to do so.

The framework of the FSAMA applies only in relation to those financial activities that are classed as *regulated*; any activity that is not regulated is outside the regulatory authority of the FSA. 'Regulated activity' has been newly defined under the FSAMA as any act that is, "an activity of a specified kind, carried on by way of a business and which relates to an investment of a specified kind or is carried on in relation to property of any kind."[36] Where by investment includes "any asset right or interest."[37] Schedule 2 of the FSAMA contains an indicative list of activities, which will be regulated if carried on by way of business. This list is supplemented by a more extensive, yet still indicative, list of activities in the Regulated Activities Order 2001.[38] The Order replaces all equivalent provisions of the Financial Services Act 1986, the Banking Act and the Insurance Companies Act 1982. The Regulated Activities Order is not fully comprehensive however, it does detail a range of specifically

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[32] Investment Services Directive 92/22/EEC and, Credit Institutions Directive 2000/12/EEC among others.

[33] FSAMA 2000, s. 19(1)

See below, section A.4 Authorisation & Permission.

[34] FSAMA 2000, s. 23(1)

[35] FSAMA 2000, s. 26

[36] FSAMA 2000, s. 22(1)

[37] FSAMA 2000, s. 22(4)

[38] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544. An outline of the activities contained in the Order can be found in Appendix 1.

excluded acts, i.e. acts that are definitely not classed as regulated.[39] It is the Treasury who has the power to specify which activities are regulated and thus it retains the ability to set, and indeed to vary the scope of market regulation. The scope of financial services regulation has been greatly extended under the new Act by the inclusion of mortgage lending, pre-paid funeral plan contracts[40] and certain Lloyd's activities, as regulated acts.[41]

As I have already mentioned, an activity will only be regulated under the FSAMA if it is carried on by way of business. Although this is very much a grey area of the new law, to date there have not been any court cases concerning the scope of the *by way of business* test, its precise meaning remains uncertain, and it is for the Treasury to determine by Order.[42] To date the Treasury has made provision by way of The Carrying on Regulated Activities by Way of Business Order,[43] which specifies certain situations where deposit taking, investment business and management of occupational pension schemes are not to be regarded as being conducted by way of business. At a more general level, it has been suggested that both frequency and commercial purpose will prove to be relevant when determining if an activity is carried on by way of business.[44] It has also been reported that the Treasury view the business test as being broader than that under the old Financial Services Act 1986, but narrower than that in the Banking Act 1987.[45] This rather vague

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[39] Broadly speaking, the exclusions under the previous legislation have all been retained. An outline of these activities can also be found in Appendix 1.

[40] Pre-paid funeral contracts are those under which an agreement is made to pay in advance for a funeral. The payments may be made in one lump sum or by way of instalments over a maximum of 10 years.

[41] General lending and credit agreements remain outside the scope of the FSAMA and under the authority of the office of Fair Trading and the Consumer Credit Act.

[42] FSAMA 2000, s. 419

The Treasury may by order detail situations in which a person will be acting in the course of business when they would otherwise not be considered to be and vice versa.

[43] The Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order No. 2001/1177

[44] Threipland, M. (2001) "Regulated and Prohibited Activities," *Blackstone's Guide to The Financial Services and Markets Act 2000*. Oxford University Press, Oxford.

[45] Freshfields Bruckhaus Deringer (2001) *The Financial Services and Markets Act 2000: A guide to the New Regime.*

position means that looking at the case law will give an indication of the outer-most boundaries but at the current time we cannot deduce a specific answer as to what is considered 'by way of business'. The test most certainly allows for an amount of flexibility and it is likely that it will be decided on a case-by-case basis with very few 'all encompassing' statements being made.

4. Authorisation & Permission

a. Authorised Persons & Permission

Having established that an activity is regulated, one must then ascertain whether the person is authorised to conduct that activity. Section 31 FSAMA outlines four groups who are authorised to conduct regulated activities under the Act; those who have obtained a Part IV permission, EEA firms within Schedule 3,[46] Treaty firms within Schedule 4,[47] and firms previously authorised under the preceding law who have been 'grandfathered' under the FSAMA.[48]

The former 'permitted persons' regime under the Financial Services Act has not been retained and persons who were formally within this regime

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[46] Schedule 3 FSAMA gives effect to the Single Market Directives concerning passport rights of authorised firms. Under these provisions a firm authorised in one Member State may conduct such activities in any other Member State without having to gain further authorisation. (This also means that an EEA firm will not have to satisfy the FSAMA threshold conditions and the 'fit and proper' test.) To exercise such passport rights an EEA firm must make a notification through its home State regulator. It should be noted however, that an EEA firm may need to gain 'top-up authorisation' if it wishes to conduct non-passportable activities which a Member State is allowed to impose authorisation requirements on.

[47] Schedule 4 FSAMA gives effect to the rights of freedom of establishment and provision of services in the EC. An EEA firm authorised by its Home State regulator can conduct an activity in any other member State provided that:

- The firm is authorised by its Home State regulator to conduct the activity is question and the FSA has been informed in writing of this authorisation.
- The Home State law provides equivalent protection or meet any requirements laid down by Community laws relating to the conduct of that activity.
- The firm has no EEA right under Schedule 3 FSAMA to conduct the activity in the manner that is wishes to.

[48] FSAMA 2000, ss. 426 &427

It is worth noting that all persons grandfathered under this clause are deemed to have received a Part IV permission.

must now apply for authorisation in the same way as everyone else, unless of course the person is within a specified exemption in the Exemption Order.[49]

For those not falling under any other category of authorised persons, Part IV permission from the FSA must be obtained for each regulated activity they wish to carry out.[50] In contrast to the previous legislation, the new rules provide for a single process of authorisation for all firms. An application can be made by an individual, a body corporate, a partnership or an unincorporated association, but not by an EEA firm that could perform the activity by exercising a passport right.[51] An application must include a comprehensive statement of the regulated activities that the applicant wishes to conduct and also the UK address where any documents can be served.[52]

When considering an application the FSA must be satisfied that the applicant meets and will continue to meet the 'threshold conditions' in Schedule 6 FSAMA. These conditions provide basic requirements for all applicants and they include issues surrounding legal status, location of head office, close links with other parties, adequacy of resources and the 'fit and proper' test. The later of these requires that the FSA must be satisfied that the applicant is fit and proper to carry on the regulated activity, having regard to any connections with third parties, the nature of the regulated activity which is sought to be carried out and the need to ensure the activity is carried out in a sound and prudent fashion.[53] The FSA has up to 6 months to process the application[54] and when the Authority is satisfied that all the conditions are met, it may issue a Part IV permission.

The FSA itself has certain procedural conditions that must be met when issuing Permission; it must detail the activities for which permission has

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[49] The Financial Services and Markets Act 2000 (Exemption) Order 2001 No.1201

[50] The FSA has, by way of the Authorisation Manual, produced detailed guidance for those unsure of their status and need for authorisation.

[51] FSAMA 2000, s.40

A passport right is only exercisable where the body is authorised to conduct the activity in the home state. Where the body is not expressly authorised to conduct the activity in the home State and it wishes to conduct this activity in the UK it must apply for Part IV permission in relation to this activity.

[52] FSAMA 2000, s. 51

[53] FSAMA 2000, Schedule 6 Para. 5

[54] FSAMA 2000, s. 52

been granted, the investments in relation to which the activities can be conducted and the clients that the person is authorised to deal with.[55]

The FSA may also issue a Part IV permission but with conditions or requirements attached. These conditions can be both positive and negative and any limitations imposed can even extend to non-regulated activities, where the FSA considers it appropriate to do so.[56] Where the FSA anticipates that it will refuse an application or place limitations on it, the Authority must give the applicant a warning notice,[57] setting out the reasons for it's refusal and thus allowing the applicant to refer the matter to the Tribunal if it so desires.

Having received permission, the applicant is then authorised to conduct the listed activities in the manner prescribed. With regard to the general prohibition, it will not constitute a criminal offence to conduct an activity outside those for which permission has been granted but there is always a risk that disciplinary action may be taken and damages awarded.

b. Exempt Persons

Section 38 FSAMA provides that a person can be exempt from requiring authorisation, as specified by the Treasury. The Treasury can make Orders relating to a specific person, or a specific class of people, and they can be exempt in relation to all activities, specified activities, in specified circumstances or in relation to specified functions. Section 38 gives the Treasury a very broad discretionary power, which it has used by way of the Exemption Order[58] and subsequent amendments.[59]

It must be remembered that an exempted person is only exempt as regards the activity/s or situations to which the exemption relates. Hence, an exempted person will breach the general prohibition if they conduct regulated activities for which they are not exempt without first obtaining permission.

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[55] The FSA is also required to keep a record of all persons who have been granted permission.

[56] FSAMA 2000 s. 43

[57] FSAMA 2000, s. 52(6)

[58] Ibid, n.49

[59] SI 2001 No.3623, SI 2003 No.47 & SI 2003 No.1675.

The FSAMA has somewhat restricted the number of exempt persons and various members of professions who were previously exempted are now required to obtain permission. However, the Treasury does have a power to exempt specific bodies as outlined above and members of the Law Society, Institute of Chartered Accountants and Institute of Actuaries are all exempt from requiring permission.[60] Other key groups of exempt persons include appointed representatives,[61] the Bank of England, European Central Bank, International Monetary Fund and the European Investment Bank.[62] Recognised Investment Exchanges and Clearing Houses are also all exempt, in relation to activities that are part of their business as an investment exchange or clearing house.

Appointed representatives of authorised persons are exempt from requiring authorisation provided that they are a party to a contract with an authorised person and the principal has accepted in writing the responsibility for the conduct of the regulated activities under that contract. All acts are then treated as being carried out by the principal (the authorised person) and he can be liable for damages and other actions if any breach of the law should arise.

EU and Treaty firms form a special class within the Act, they are not exempt per se but neither do they need to apply for Part IV permission. This special status is derived from European law, whereby firms within the EEA have the right to conduct certain activities in other member states without needing to obtain further authorisation or permission.[63] Once an EEA firm satisfies either the rights of establishment, if wishing to establish a branch in the UK, or the services conditions, if seeking to provide a service in the UK, the firm qualifies for authorisation under the Act.[64] Having qualified for

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[60] The Financial Services and Markets Act 2000 (Designated Professional Bodies) Order 2001 No.1226

[61] FSAMA 2000, s. 39

This provision is similar to the former s. 44 FSA 1986, however unlike under the FSA 1986, banks and building societies cannot act as appointed representative and hence they are outside the scope of the exemption.

[62] Provided for in The Financial Services and Markets Act 2000 (Exemption) Order 2001, Schedule 1. However they are not exempt in relation to insurance business.

[63] Special provisions for UK firms wishing to exercise passport rights are detailed in Para 19 Schedule 3 FSAMA.

[64] FSAMA 2000, Schedule 3 Para. 12.

authorisation, the firm then automatically has permission to carry on those permitted, regulated activities in the UK.[65]

With regard to Treaty firms, the requirements of Para 3(1) Schedule 4 FSAMA must be met before they are permitted to conduct the activity in the UK.[66] The responsibility for authorisation and prudential supervision of all EEA and Treaty firms exercising rights in the UK remains with the home state authority and not with the FSA.

c. Withdrawal of Permission

Following the grant of permission, the FSAMA provides for two ways in which this permission can be varied or withdrawn; by application of an authorised person or by use of the FSA's own initiative power.[67] Variation of the permission may be by altering or removing the regulated activities for which permission is granted or by removing or varying requirements imposed on the permission. The Authority may make such alterations at the request of an authorised person, where the authorised person is failing to meet the threshold conditions discussed above, where the applicant has not carried on a permitted activity over a period of at least 12 months, where it is in consumer interests to do so or where the FSA wished to assist an overseas regulator.[68]

Where the FSA seeks to make use of it's own initiative power, it is required to give the person a warning notice and, following cancellation of the permission, a final decision notice.[69]

The conditions of establishment and service provision are set out in detail in Paras. 13&14 Schedule 3 to the FSAMA.

[65] FSAMA 2000, Schedule 3 Para. 15

[66] Ibid, n.47

[67] FSAMA 2000, ss. 44-45

[68] FSAMA 2000, ss. 44-47

[69] FSAMA 2000, s. 54

However, where the FSA considers it necessary it may exercise it's own initiative power with immediate effect and without prior representation or warning.

5. Performance of Regulated Activities

a. FSA Controls

Part V FSAMA provides the FSA with two controls over individuals who carry out regulated activities. The first, contained in s.56, is that the FSA can prohibit an individual from conducting certain functions if it feels that he is not 'fit and proper' to do so. The second is that all persons who perform 'controlled functions' under an arrangement with an authorised person must have FSA approval.[70] An authorised person entering into such arrangements is under a duty to take reasonable care to ensure that the person has FSA approval to conduct the function to which the arrangement relates. When considering the 'fit and proper' test the FSA will have regard to whether the applicant has obtained a qualification, has had training and possesses a level of competence.[71] The FSA has a maximum of three months to consider an application and decide on its outcome.

Section 71 FSAMA provides that a breach of any of the duties of care within this part of the Act by an approved person is actionable by a private person who suffers loss as a consequence of the breach.

b. Financial Promotion

The FSAMA has made significant changes to the restrictions on financial promotions by *unauthorised* persons. Prior to the Act there were separate provisions on advertising and cold calling; now there is a single regime under s. 21 for all forms of promotion. Section 21 provides that "A person may not, in the course of business, communicate an invitation or inducement to engage in investment activity." The element causing most discussion has been, 'in the course of business,' which indicates that communication which are between private individuals or conducted in a personal capacity will not be within the prohibition. The Treasury has the power to determine the meaning by way of Order, but it has yet to exercise this power and so the phrase is to be

[70] FSAMA 2000, s. 59

[71] FSAMA 2000, s. 61

given its "ordinary or natural meaning."[72] An interesting view is that of Thomas J. (2002)[73] who considered the use of the same phrase in areas of consumer protection law. Thomas concluded that the Treasury should be expected to set down principles from which a decision can be made on a case-by-case basis, having regard to all the circumstances, but suggested that the three-part test laid down in Stevenson v. Rogers[74] may prove attractive. This would leave the FSA with strong powers of interpretation but for the time being the FSA statement that "a commercial interest on the part of the communicator is necessary" is the most guidance we have on the matter.[75]

The prohibition on financial promotion in Section 21 is subject to certain exceptions, listed briefly in s. 21(2) and in more detail in the Financial Promotions Order.[76] The most important exemption is where an authorised person has approved the content of the communication.[77] The essence of this exemption is that an authorised person may approve the content of a communication made by an unauthorised person provided that the purpose is specifically to allow the communication to take place free from the restriction of s.21. The authorised person effectively has the same responsibilities when it approves a communication as when it makes its own communication.[78] This includes things such as taking responsibility for the accuracy of the financial promotion and meeting the disclosure requirements. It is important to note

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[72] See Appendix 1 of Authorisation Chapter, FSA Handbook. This explanation is less than adequate and the author feels that essentially it means that the FSA will determine the issue on a case-by-case basis in light of the surrounding circumstances.

[73] Thomas, J. 2002. The Financial Services and Markets Act 2000 and Financial promotions – The Meaning of 'In The Course of Business', *International Company and Commercial Law Review* Vol.13 (6): 233-236

[74] [1999] 2 WLR 1064

In this case it was agreed by the parties that a *sale* was in the course of a business if it was "a) a one-off venture in the nature of the trade carried through with a view to profit, b) a sale which is an integral part of the business or c) a sale which is merely incidental but undertaken with a degree of regularity." (For our purposes the facts are irrelevant as this was a case dealing with consumer law rather than financial promotion.)

[75] See Appendix 1 of Authorisation Chapter, FSA Handbook.

[76] The Financial Services and Markets Act 2000 (Financial Promotions) Order 2001 No.1335

[77] FSAMA 2000, s.21 (2)(b)

[78] FSA Handbook Conduct of Business, Chapter 3, 3.12.1

that the unauthorised communicator will not be in breach of the restriction simply because the approver has breached the rule.

The Order has largely retained the scope of the previous regimes for insurance, deposits and investment services and it had also retained the majority of the prior exemptions.

The rationales behind the introduction of the single financial promotion scheme are first, and quite simply, that both of the previous regimes related to financial promotion and hence it would be logical to combine the two. In addition it was felt that the government aims to 'streamline and modernise' and to deal with evolving forms of communications technology were best achieved through use of a single regime. However it has been argued that the previous system was justified, as different forms of promotion deserve different treatment.[79] Concerns surrounded the introduction of the regime and the noticeable extension of regulatory scope. Not only does the FSAMA encompass additional forms of communication but also its territorial scope is far greater. The new rule applies to communications that originate both inside and outside the UK, provided they are capable of having effect inside the UK.[80]

One must bear in mind that the FSAMA is not the only piece of legislation applicable to regulation of financial promotion. Regard must also be had to any general advertising directives and regimes such as under the Advertising Standards Authority.[81] One must also be aware that the Public Offers of Securities Regulations 1995[82] and the Telecommunications (Data Protection & Privacy) Regulations 1999[83] are both applicable to financial promotions.

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[79] Ibid n.45

[80] "Capable of having effect inside the UK" is thought to have a very broad meaning such that it includes any communication *capable* of resulting in any UK person engaging in the communicated activity.

[81] It should however be noted that investment advertisements made by authorised people under the old FSA 1986 were not governed by the Control of Misleading Advertisements Regulations SI 1998 No.915.

[82] SI 1995/1537

[83] SI 1999/2093

6. Official Listing

Provisions regarding official listing in the UK can be found in Part VI FSAMA.[84] In the most part the FSAMA provisions replicate those contained in the FSA 1986, however there are a few significant changes to the previous law. In May 2000 power was transferred from the Stock Exchange to the FSA, and hence the FSA is now the named UK Listing Authority ("UKLA"). One of the major reasons behind this transfer of control was because the Stock Exchange had chosen to become a public company. Power over admission to trading has not changed hands and the Stock Exchange and other exchanges within the UK continue exercise this function. The Treasury has also retained the authority to transfer some or all of the UKLA functions to other bodies, but it must have written consent from the FSA before it can do so.[85]

The general duty of the FSA under this part of the Act simply mirrors that contained in Part I, i.e. the FSA must have regard to efficient and economic use of resources and the principle of proportionality etc. As the UKLA, the FSA has the task of maintaining the official list and entrance to it. Rules for entrance to the list are contained in the Listing Rules and the FSA must be satisfied that these have been complied with before admission is granted.[86] The FSA also has the functions of suspending listing where necessary, enforcing the Listing Rules,[87] providing documentation and guidance and investigating breaches of the Rules.

Major changes were introduced by the FSAMA with regard to sponsors.[88] Under the FSA 1986 the official status of sponsors was unclear, now sections 88 and 89 have clarified their position, rights and obligations. The FSAMA also introduced some fundamental changes with regard to the

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[84] Regulation of official listing is also contained in the Admission to Listing Directive 79/279/EEC, the Listing Particulars Directive 80/390/EEC and the Interim Reports Directive 83/121/EEC.

[85] FSAMA 2000, s. 72(3)

[86] FSAMA 2000, s. 75(1)

[87] However the FSA does have the power to dispense with or modify the Listing Rules, on a case-by-case basis, where it is felt it would be appropriate to do so.

[88] A sponsor is any person approved by the FSA for the purpose of the Listing Rules, often they act as intermediaries between issuers and the Listing Authority, now the FSA.

imposition of penalties. Section 91 provides the FSA with the power to impose penalties on any person in breach of the Listing Rules.[89]

7. Market Abuse

Part VIII FSAMA has created a new offence of market abuse which works alongside the provisions in the Criminal Justice Act 1993 and the Takeover Code. Section 118 states that market abuse arises where behaviour occurs "in relation to qualifying investments"[90] and it "satisfies any one of the conditions set out in subsection 2". These conditions are that the behaviour is:

- Based on information not available to those on the market, but which would be relevant information if available.
- Likely to give a regular user a false impression as to supply / demand / price / value of the investment.
- Likely to be such that a regular user would regard it is likely to distort the market.[91]

In addition to the above requirements, the behaviour must also satisfy the test that a "regular user" would consider the behaviour to be a failure to observe the standard of behaviour that he would "reasonably" expect in the same circumstance.[92] That later part of the test has become known as the "regular user" test and is itself subdivided into three parts.[93] As a whole, the

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[89] Under the new rules the FSA has far more flexibility when imposing penalties for breached of the Listing Rules.

[90] What amounts to a qualifying investment is to be determined by Order of the Treasury. See: The Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 No.996. The act also makes specific provision for acts which take place on markets which are electronically accessible in the UK to be within the scope of the market abuse regime.

[91] The behaviour must satisfy just *one* of the conditions set out in s. 118 (2).

[92] Further information on the Regular User test can be found in the market Conduct section of the FSA Handbook. It states that a regular user will consider: the characteristics of the market, the rules and regulations and any applicable laws, prevailing market mechanisms, the position of the person in question and the standard reasonably expected of them and the need for market users to ensure they do not unfairly damage the interests of investors.

[93] FSAMA 2000, s. 118(2)

market abuse test is effects based, i.e. there is no requirement of intent on the part of the abuser[94] and hence the potential scope is far broader than any applicable criminal laws. Examples of behaviour amounting to market abuse include the misuse of information, misleading statements and insider dealing.

Part VIII is arguably one of the most controversial aspects of the new regime,[95] in part due to the wider range of abusive acts and also because it applies to all persons. The aim of this section of the Act is stated as being to locate a balance between the prevention of abuse and promotion of accepted practices, by making the market more open and fair. The territorial scope of market abuse extends only to acts occurring within the UK and acts that occur in relation to a qualifying investment traded on a market situated in the UK.[96]

The FSA has the task of preparing a code of guidance, indicating which activities are likely to be market abuse and which are not. The code must also set out the factors that the FSA will take into account when deciding such matters. Any acts described in the code as not amounting to market abuse can be regarded as 'statutory safe harbours'.

Once an act is deemed to be abusive conduct the sanctions are potentially very severe indeed. The FSA can impose an unlimited financial penalty, it can publish a public censure and it can apply for a court injunction or restitution order.

8. Competition Scrutiny

a. FSA Actions

Under the new statute, the FSA's rules, codes and practices are all subject to competition scrutiny by the Director General of Fair Trading and

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This test is the equivalent of the English courts' "reasonable man test" and is used as a means of fixing the accepted level of market conduct. It is essentially an objective means of determining whether an act amounts to market abuse, but it also requires that all the relevant circumstances of the case to be taken and thus has a subjective element.

[94] Nonetheless the Act makes exclusion where the person " believed on reasonable grounds or took reasonable precautions and exercised all reasonable diligence."

[95] Walker, G. (2001) Penalties for Market Abuse IN: Blair, M. ed. *Blackstone's Guide to the Financial Services and Markets Act 2000*. Oxford, Oxford University Press.

[96] FSAMA 2000, s. 118(5)

the Competition Commission. The role of the DGFT is similar to that under the FSA 1986, he is under a duty to review and report on any FSA practices and provisions which may have a "significant, adverse effect" on competition.[97] The role of the Competition Commission, to consider reports by the DGFT that conclude that there has been an adverse affect on competition or where the DGFT has referred the matter to the Commission for consideration, is a new role under the FSAMA. The Commission has three options open to it, it can conclude that there is no such effect on competition, that there is an effect but it is justified or that it is not justified and action must be taken by the FSA. Where the Commission decides that there is an adverse effect on competition which is justified, the Treasury has the power to overturn the decision and it can order the FSA to take action, but only in exceptional circumstance.

No references have been made to the Competition Commission to date, however the Office of Fair Trading announced in November 2003 that it is to begin an assessment of the impact of the FSAMA on competition in the market.[98]

b. Competition Between Financial Intermediaries

The issue of competition between financial intermediaries is dealt with not by the FSA but by both the Office of Fair Trading ("OFT") and the Competition Commission. The objective of the OFT is to "make markets work well for consumers."[99] To achieve this objective the OFT seeks to remove anti-competitive behaviour from the market place and ensure rigorous competition between financial service providers.

The Competition Commission is an independent body and works in response to references made to it by OFT to investigate issues that may affect the level of competition in the market.

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[97] FSAMA 2000, s. 160

[98] http://www.oft.gov.uk/News/Press+releases/2003/PN+142-03.htm

[99] http://www.oft.gov.uk/about/default.htm

9. Sanctions & Enforcement

a. Information Gathering & Investigations

Part XI FSAMA gives the FSA five powers under the title of "information gathering and investigation." First, the FSA has the power to gather information that is reasonably required in connection with the exercise of one of its functions.[100] There is no need for the FSA to obtain a formal warrant nor must there have been a prior breach of regulation by the body from which the information is requested. This power applies in relation to past and present authorised persons and also anyone connected with authorised persons.

The second is the power to request reports on any matters that could form the subject of its first power (above).

Thirdly, the FSA has the power to conduct general investigations into authorised and previously authorised persons and appointed representatives.[101]

Fourth, where it appears that there has been a breach of regulation or that a person may be guilty of an offence under the Act, the FSA can appoint an investigator to investigate the situation.[102]

Finally the FSA has a new power to investigate 'any matter' to assist an overseas regulator.

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[100] FSAMA 2000, s. 165

[101] Under sections 167 an investigation may be commenced where:

- It appears that there is good reason to do so.
- Where circumstances suggest a contravention of the insurance business rules.
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[102] FSAMA 2000, s. 168

For example:

- If it appears that there has been:
  - Insider dealing.
  - A breach of the general prohibition.
  - Unlawful financial promotion.
  - Market abuse.
- Or if the circumstances indicate a breach of any other regulation.

The FSA powers of investigation are far wider than anything under the old regulatory regime.

In addition to these five powers the FSA also has the authority to enter premises under warrant[103] in three situations; where there are reasonable grounds to believe there are documents on the premises which could be required and which would not be produced if requested, if there are reasonable grounds to believe an offence which instigated an investigation is being committed on the premises or if there has been non-compliance with a request to produce information.[104] When exercising these powers, the FSA is required to give prior notice, unless doing so would be likely to frustrate any investigation.

Under the FSAMA any failure to cooperate may be dealt with as if the individual is in contempt of court. This is fair less severe than under the old rules, whereby failure to cooperate could be considered a criminal offence.

In addition to the powers within Part XI FSAMA, the FSA may need to gather information on a general basis to satisfy its supervisory role. One tool explicitly used by the FSA is 'mystery shopping' where by a person approaches a firm as a potential customer in order to gain information about the firm and how it sells financial products.[105]

b. Disciplinary Measures

Under Part XIV FSAMA the FSA has two disciplinary tools at its disposal, public censure and financial penalties.[106]

With regard to the imposition of financial penalties, the FSA is not simply at will to does at it likes. The principle of proportionality contained in section 2(3)(c) means that any penalty imposed must be proportionate to the wrong doing to which it relates. In assessing the level of the penalty the FSA

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[103] The warrant must be applied for by the FSA, Secretary of State or an appointed investigator and it may then be issued by a 'justice of the peace' (a magistrate) and will be enforced by a police office.

[104] FSAMA 2000, s. 176

[105] See the Supervision section of the FSA Handbook.

[106] This statement can be found in the Chapter 14 of the Enforcement section of the FSA Handbook.

must consider the seriousness of the offence, if it was deliberate or reckless and whether the offender is an individual or a firm. In addition, the FSA is not at liberty to impose both a fine and public censure together, it must choose one or the other. Fines and public censures may be imposed where a firm has breached a requirement under the Act or where an approved person is guilty of misconduct and it is considered appropriate to impose such measures.

The FSA can apply for an injunction or restitution against anyone knowingly concerned in an offence; this can include individual persons and employees. The FSA also has the power to impose a restitution order itself but only against a firm and not an individual.[107] The FSA can vary or even cancel a person's permission to conduct regulated activities,[108] and it can withdraw its approval with regard to any approved persons.

The FSA is required to publish a statement detailing the factors it will consider when deciding which sanction to impose, and the level of any financial penalty.

c. Financial Services Compensation Scheme

Under Part XV FSAMA, the FSA has established a body corporate to conduct the Act's single compensation scheme.[109] Prior to the FSAMA, compensation issues arising where an authorised body was unable to meet its liabilities were dealt with by five independent schemes, each with different requirements and limits. The FSAMA has unified compensation provisions but has afforded the Financial Ombudsman Service ("FOS") the power to provide separate compensation funds to deal with different types of claims.

The objectives of the new scheme are to provide a safety cushion for market users and to uphold consumer confidence in the market. One of the key changes other than unification is that, under the new system,

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[107] The FSA must apply to the court if it seeks to impose a restitution order against an individual.

[108] FSAMA 2000, s.33

[109] The compensation body enjoys immunity from action in the same way as the FSA and hence the only way to challenge it is through the process of judicial review.

compensation is principally awarded to satisfy the claims of individuals and small businesses and not those of large firms.

d. Financial Ombudsman Service

The objective of the new FOS is to provide a method by which "certain disputes may be resolved quickly and with minimum formality by an independent person."[110] Essentially it provides a method of alternative dispute resolution for customers. The new scheme is a replacement of no less than eight previous services that were all independent of one another. The FOS is a body corporate elected by, but independent of the FSA. When determining a complaint the FOS is to have regard to what is fair and reasonable in all the circumstances, this requires consideration of the relevant regulations, rules, codes of conduct and statements of good practice.

Under the scheme the FOS will decide the amount and type of redress that the complainant is to receive, this can include payment of compensation and ordering the firm to take steps considered to be 'just and appropriate'. If the complainant accepts any such determination the respondent will be bound by it.

Alongside the new FOS scheme, the FSA has new powers to ensure that firms establish their own complaints handling and resolution procedures.

As with most, if not all of the novel features of UK financial services regulation under the FSAMA, the Ombudsman scheme has raised many questions and concerns. Most importantly are issues surrounding its compatibility with obligations under European Convention for Human Rights.[111] There are also concerns surrounding the fact that a determination can bind the respondent at the option of the consumer but not vice versa, that there is no appeals procedure and also that the process is so informal.[112]

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[110] FSAMA 2000, s. 225(1)

[111] Convention for the Protection of Human Rights and Fundamental Freedoms. Available from: http://www.echr.cow.int/Convention/webConvenENG.pdf

[112] These issues were all noted in Freshfields Bruckhaus Deringer (2001) ibid, n.45

10. Lloyd's

The decision to include Lloyd's within the new regulatory framework, and subject the Market to proper prudential supervision, came at a time where scandal and major claims had rocked the institution. Under the FSA, Lloyd's regulation of the insurance market is now subject to an external supervision regime. Some of its supervisory duties are conducted directly, such as supervision of members' agents and Lloyd's advisers, and others are undertaken by Lloyd's but under the direction of the FSA. Although Lloyd's is itself an authorised person, and all existing authorised persons were 'grandfathered' when the FSAMA came into force, the FSA has the power to cancel or restrict a person's authority.

The principal concern of the FSA with regard to Lloyd's is the protection of policyholders from the risk of claims not being paid. To perform this function the FSA must remain aware of the affairs of Lloyd's and it must review on a regular basis whether there is a need for it to exercise any of its powers. The FSA requires that Lloyd's issues a set of rules conferring protection on policyholders, produces an annual statement of business and publishes copies of its annual accounts.

Complaints against Lloyd's continue to be passed through the Lloyd's Complaints Department and only following this will a complain be dealt with by the FSAMA Ombudsman Scheme, which has replaced the Insurance Ombudsman Bureau.

The FSA also has the authority to exercise its powers of information gathering, investigation and discipline over Lloyd's itself and any of its participants.

Due to the safety net already in place through the Lloyd's Central Fund arrangements, the decision was taken for it to be exempt from the Financial Services Compensation Scheme.

11. Insolvency & Failure of Financial Intermediaries

The FSA recognises that it is both impossible and undesirable to achieve a level of 'zero-failure' in financial markets.[113] Given this, there will undoubtedly be cases of failing firms and insolvency of financial intermediaries. The FSAMA makes provision for such occurrence in Part XXIV. Under this part of the Act the FSA is given a wide range of powers, far wider than under the preceding legislation, to assist in achieving it's statutory objectives.

a. Voluntary Arrangements

The term 'voluntary arrangements' refers to an arrangement for the repayment of debts between a company in financial difficulty and its creditors.[114] Where a voluntary arrangement concerning an authorised person has been agreed, the FSA is entitled to be heard at any hearing relating to the application.[115] The Authority is essentially to be treated as though it were a creditor of the authorised person. The FSA is to be given the same notice of hearings as any creditors of the authorised person would be entitled to,[116] and can attend and participate in meetings of its creditors.[117]

b. Administration Orders & Receivership[118]

As an alternative to winding up, an administration order may be made so that the company continues to operate but under the supervision of an

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[113] Financial Services Authority. (2000) A New Regulator for the New Millennium. *FSA Publication*. Available from: http://www.fsa.gov.uk/pubs/policy/p29.pdf

[114] Firms in financial difficult may enter into voluntary arrangements as an alternative to going into liquidation.

[115] FSAMA 2000, s. 357

[116] FSAMA 2000, s. 358(4)

[117] FSAMA 2000, s. 358(5)

[118] An administrator is appointed to get the company out of financial trouble, or in the worst case he will achieve the best result for the creditors of the company.

administrator. With regard to administration orders and receivership the FSA is again given strong powers. The FSA can petition to the court for an administration order where the body concerned is or has been an authorised body, or where the body has been conducting a regulated activity.[119] The Authority is again treated as though it was a creditor of the company and is given powers to participate to hearings accordingly.[120] The provisions on administration orders do not at present relate to insurance companies, although the Act does provide the Treasury with the power to extend the scope to include insurers at such time as it chooses.[121] With regard to receivership, the FSA is given the same rights as if it were an *unsecured* creditor[122] and where a receiver is appointed to a company he is obliged to inform the FSA if it seems as though the company has been acting in breach of the general prohibition.[123]

c. Winding Up[124]

The FSAMA provides the FSA with powers in situations of both voluntary and court ordered winding up. The FSA is again equipped with rights to be treated as if it were a creditor.

Where it is a case of voluntary winding up,[125] the FSA only has authority with regard to authorised persons.[126] Under section 365 the FSA is entitled to be heard at court hearings and participate in meetings and receive copies of any documents sent to creditors of the company.

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[119] FSAMA 2000, s. 359

[120] FSAMA 2000, s. 362

[121] FSAMA 2000, s. 360(1)

[122] FSAMA 2000, s.363

[123] FSAMA 2000, s.364

[124] In the case of insolvent companies a liquidator will be appointed to wind-up the company.

[125] This is only available where the company to pay its debts.

[126] That is, the FSA does not have any authority in proceedings involving the voluntary winding-up of any unauthorised body which has been conducting regulated activities in breach of the general prohibition.

The FSA's powers in relation to winding up by the court have been extended from those under the Financial Services Act 1986 to include winding up of bodies who are not authorised but are acting in breach of the general prohibition.[127] The FSA itself may petition to the court for a body to be wound up. There are two grounds on which the court order the winding up of the body:

- Where the body is unable to pay its debts.
- Where is would be considered 'just and equitable' to do so.[128]

As a limitation to the FSA's powers to petition for winding up, the FSA is not allowed to petition for the winding up of any firm which is authorised under Schedule 3 FSAMA, i.e. EEA firms, and also any Treaty firms authorised under Schedule 4 FSAMA, unless it has been requested to do so by the firms home state regulator.[129]

d. Bankruptcy[130]

Under section 372 FSAMA the FSA has been given an important new power in relation to issues of bankruptcy. The FSA can now petition to the court for a bankruptcy order where a body is unable to pay a regulated debt or where it *appears* that the body will be unable to pay a regulated activity debt.[131]

12. Territorial Scope of the Act

It is perhaps simpler to consider the territorial scope of the act in three parts. First, the Act obviously has effect where both the person conducting the regulated act and the consumer are located in the UK. There is no

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[127] Under the Financial Services Act 1986 the authority could petition to the court for the winding up of both authorised firms and appointed representatives but not unauthorised firms.

[128] FSAMA 2000, s. 367(3)

[129] FSAMA 2000, s. 368

[130] Bankruptcy arises in the case of an insolvent individual or partnership.

[131] FSAMA 2000, s. 372(2)

requirement of permanent establishment in the UK, just that all parts of the act take place within the UK. Secondly, the situation of activities carried on 'outward from the UK', where the consumer is located outside UK territory the situation is far less straightforward. Section 418 sets out four situation in which an activity will be considered to be within the UK, where it would not otherwise be so considered. Thirdly, application of the Act to activities conducted 'inward to the UK'.

13. The Respective Roles of the Regulatory Bodies

Although the FSA is now the UK's single financial services regulator, the Bank of England and the Treasury both have keys roles in the regime. The Memorandum of Understanding[132] between the regulatory bodies provides a framework for co-operation, clear descriptions of the roles of each of the bodies involved and "Helps ensure timely and efficient coordination and allocation of work."[133] It begins by explaining the four fundamental principles forming the basis of the division of regulatory power under the FSAMA:

- Clear accountability of the regulatory bodies.
- Transparency of functions.
- No overlap of functions.
- Exchange of information to ensure efficient discharge of functions.

At a general level, each body is required to inform the others about any changes in policy and to consult the other body in advance where it is felt that the policy change may impact on the responsibilities of the other body. The Bank of England is represented on the FSA Board and likewise, the Chairman of the FSA has a seat on the Bank of England Board.

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[132] Financial Services Authority. (1997) Memorandum of Understanding Between HM Treasury, the Bank of England and the FSA. IN: Financial Services Authority: An Outline, *FSA Publication.* Available from: http://www.fsa.gov.uk/pubs/policy/launch.pdf

[133] C. Briault, C. (2002) Revisiting the Rationale for a Single National Financial Services Regulator. *Financial Services Authority Occasional Paper*. No. 16.

Available from: http://www.fsa.gov.uk/pubs/occpapers/op16.pdf

a. FSA

The FSA is the only one of the regulatory bodies to have its functions and tasks set out in the FSAMA. The FSA is in charge of the process of authorisation of firms, prudential supervision of the industry and also for conducting procedures in response to any problems that arise in the industry. In addition to these tasks the FSA is responsible for supervising the financial markets and for providing advice on the impact of regulatory policy.

With regard to 'law making' powers, the FSA is given the tasks of rule making, the issue of directions and the provision of codes of practice. The new rule making powers broadly follow those under the FSA 1986, however the Authority does not require Parliamentary approval when making its rules. Given that these rules are a form of binding, secondary legislation and non-compliance can result in severe consequences for a firm, this indicates a significant shift in power from Parliament to the FSA.

The FSA is also responsible for creating and maintaining a 'handbook' of guidance and information on the law under the FSAMA. This 'guidance' is not binding on firms[134] and the Act makes no mention of consequences for contravention of the guidance, but generally speaking an authorised body will rely on the guidance as evidence of the FSA's views on the application of the law. The issue of any guidance by the FSA Board is subject to prior consultation.

b. Bank of England

When the FSAMA came into force the Bank of England departed from all of its supervisory responsibilities but it remains responsible for ensuring overall financial stability of the markets and the operation of monetary policy. The task of maintaining overall financial stability involves five key responsibilities:

- Monitoring the stability of the monetary system.

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[134] Guidance issued by the FSA has been said to be a form of 'quasi-legislation'. See Toube, D. & Chavda, J. IN Perry (2001) *The FSAMA: A Practical Legal Guide*. London, Sweet & Maxwell.

- Advising the Chancellor on problems in the payments systems. This includes a role in the development of the system to reduce systemic risk.
- Giving an overview of the system and advising of any effects that proposed developments would have on financial stability.
- Undertaking official financial operations in exceptional circumstance.
- Ensuring the efficiency and effectiveness of the market and promoting the City.[135]

c. Treasury

The Treasury holds no operational responsibilities under the new regime, all of these are now with the FSA, however the Treasury remains a powerful body under the FSAMA.

The Treasury has a key role in ensuring the accountability of the FSA and reporting to Parliament on its findings and it is also liable for the "overall institutional structure of the new regime."[136]

Although the FSA is thought of as the central institutional body under the Act, its powers are all controlled and subject to review by the Treasury. As I have already mentioned, the Treasury has the authority to alter areas of the law by order, among other things the Treasury must determine what constitutes a regulated activity and it can transfer the supervisory powers of the FSA to another body if it thinks necessary.

d. Financial Services and Markets Tribunal

The new Financial Services and Markets Tribunal is an independent and impartial body established under the FSAMA to deal with the referral of certain decisions made by the FSA. The Tribunal is responsible for hearing complaints about decisions and notices issued by the FSA and where necessary

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[135] Memorandum of Understanding, ibid, n.132

[136] Memorandum of Understanding, ibid, n.132

it must determine what action must be taken by the FSA. This may seem like a huge power but it is drastically limited by sections 133(6) and (7) FSAMA. Under these provisions the Tribunal cannot direct the FSA to take an action that is ultra vires the FSA in the given situation. This provision not only restricts the Tribunal but also ensures that the Tribunal cannot act beyond the scope within which the FSA can act. Orders made by the Tribunal are enforceable as if they are orders of a county court[137] and the FSA is obliged to act in accordance with any such orders. Appeals to the Court of Appeal can be made against decisions of the Tribunal, but only on a point of law.[138]

e. Office of Fair Trading & Competition Commission

As mentioned above, OFT and the Competition Commission are responsible for ensuring an appropriate level of competition between financial intermediaries. The Competition Commission is also responsible for reporting on any anti-competitive effects of FSA actions, following a report by the DGFT.

[137] FSAMA 2000, s. 133(11)

[138] FSAMA 2000, s.137(1)

B. BACKGROUND TO THE FSAMA

"The need of a single regulator has been as universally accepted as the need for a child support agency."[139]

1. Motivation for the Regulatory Reform

a. Motivation for Reform

The introduction of the FSAMA signified the climax of many years of gradual change in the UK financial market systems and a refusal to tolerate the scandals witnessed during the late 20th Century.

Prior to the 1980's the UK markets saw little in the way of statutory regulation; the dominant form of monitoring was self-regulation and there was little use of independent regulators. Due to the developments over the previous few decades, which spanned all areas of the markets, this system of financial regulation had become inadequate.

The banking crisis of 1973 resulted in statutory regulation of banks for the first time by way of the Banking Act 1979, but shortly after the collapse of Johnson Matthey Bankers in 1984 led to a need for even greater legislation to govern banking activity. Changes in the banking sector did not stop here; the nature of the system had changed and it was no-longer the exclusive 'old-boy network' that it had once been. Just four years after the reform, the BCCI scandal thrust the banking sector back into the limelight. The report that followed placed heavy criticism on the Bank of England and highlighted weaknesses in supervision.[140] The final straw came with the dramatic collapse of Barrings Bank in 1995. Once again, the Bank of England was deemed to have failed in its performance as the banking regulator.

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[139] Per Lord Lipsey, vol. 610 HL, 21. February 2000, c.59.

[140] The Bank of England is currently defending itself in a case against BCCI liquidators. The plaintiffs allege that the Bank of England is guilty of misfeasance of public office and they are claiming £1bn damages from the Bank.

In the mid-80's we saw the Big Bang of the Stock Exchange in which the Stock Exchange rulebook underwent three major changes governing the way shares were to be traded. The consequences were increases in its competitiveness and international character and hence the existing forms of regulation became inappropriate.

In 1981 Professor Jim Gower was commissioned to produce a report on Investor Protection in the UK financial markets.[141] There were concerns surrounding the treatment of investors by salesmen who had incentives to sell certain products and questions were also raised on the issue of bankruptcy following the collapse of Norton Warburg. Gower is understood to have been in support of a system of full statutory regulation but he concluded that this would not have been appropriate in the UK at the time. The Report proposed an update of the existing system to one of "self-regulation inside a statutory framework." The basic principles of his report were accepted and a government White Paper was produced in 1985, followed by the introduction of the Financial Services Act 1986.[142]

The key concept of the FSA 1986 was positive supervision[143] involving a process of authorisation before firms could conduct market activities. Each authority (Self-Regulatory Organisation) was in charge of a range of activities and intermediaries could apply to the relevant SRO or directly to the SIB for authorisation. Any changes in the activities being conducted by the intermediary required further authorisation.

And so the regulatory reforms had begun. However, when the Conservative government introduced the FSA 1986 they did somewhat of a half-job. It has been suggested that they did not want to be involved in a "radical overhaul" of the regulatory framework and the potential for new problems that could follow.[144]

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[141] Gower, J. (1984) *Review of Investor Protection – A Discussion Document*. HMSO, London.

[142] The FSA 1986 did not extend to Lloyd's regulation but at the time the Act was seen as giving a wide scope of statutory regulation.

[143] Lomax, D.F. (1987) *London Markets After the Financial Services Act*. Butterworths, London.

[144] Sarker, R.L. (1998) Reform of the Financial Regulatory System. *Company Law*. Vol. 19(1), pp. 11-13

The problems under the FSA 1986 were inherent in the two-tier structure of regulation. A system with so many regulatory bodies[145] unavoidably had overlaps and gaps between authorities, both of which made for an inefficient regulatory system. Consumers and intermediaries had no certainty as to which authority they must use and which they were governed by; thus creating a lack of confidence in the system. The 'financial scandals' of the '80's did not stop; events at Lloyds lead to an inside report recommending the need for external regulation and the full extent of pensions mis-selling began to unfold. In an assessment made by Andrew Large, chairman of the SIB, the problems with the regulatory system were said to be:

- Lack of clarity of regulatory objectives.
- Lack of confidence in the system.
- Cost effectiveness, and
- Undetected fraud.

As if this wasn't enough, the late 20th Century also witnessed the advent of 'blurring' of financial services.[146] Not only did firms begin providing a wider range of services, but also the distinct character of the services provided began to diminish. Couple these with the influx of many new types of financial services and the telecommunications revolution and it is clear that something had to change.

By the end of the millennium, the Financial Services Act had become outdated by further market developments. The City was, and still is growing in internationalisation, with an ever-increasing number of firms participating on a worldwide level. The increasing influence of EC law which demanded compliance by the UK and the provision of further new financial services which did not come within the traditional classification system meant that by the turn of the century reform was once again "long overdue."[147] A system involving self-regulation was no longer appropriate in the UK. Above all the

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[145] Under the Act there were five key regulators in additions to the SROs and RPBs; The SIB, the main regulatory body, The Bank of England, The Department of Trade & Industry (DTI), Lloyd's (who was exempt from the FSA 1986) and The Takeover Panel.

[146] Blurring is the term used to describe the situation where financials services lose their distinct character and firms no longer fall within a traditional division of service provision.

[147] Brown, G. ibid, n.2

regulatory regime in operation was lacking the levels of accountability, efficiency and clarity demanded by today's society. This desire for consistency of regulation, rationalisation and a "coherent body of law"[148] paved the way for the reforms. Howard Davies' somewhat brief conclusion was that, "the Government's decision to replace the previous patchwork quilt of financial regulators with a single entity was amply justified." [149]

b. Ulterior Motives for Reform?

It may be a somewhat cynical view but I find it necessary to consider the possibility of a virtually hidden objective of the Labour Government, for the UK to be the worldwide 'leader of reform;' to create a system that other countries would chose to follow. Evidence of this can be seen in a speech made by Alistair Darling in 1998 when he said, "We are creating a new regulator for the new millennium. A single regulator to replace the outdated divisions of responsibility in the past … The Financial Services Authority will become "*the role model for the future*."[150] A later speech by Stephen Byers echoed the same belief; "These reforms are the opportunity to apply best practice across the board…*setting an example for financial regulation around the world*."[151]

True, all Governments should in some way aspire to be the envy of the world, but this should be results driven. There is no advantage to be gained from being the first to do something, if it would be more beneficial to observe the approach taken by others first. If a system of reform is adequately justified then it should undoubtedly be followed but patience is sometimes a virtue.

In an equally sceptical tone is the view that the reform was partially motivated by hostilities between the Chancellor and the Governor of the Bank of England, but one can only speculate on the truth of this.

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[148] Brown, G. ibid, n.2

[149] Davies, H. (2003) Speech at the FSA Annual Meeting. Available from: http://www.fsa.gov.uk/pubs/annual/ar02_03/index.html

[150] Per Alistair Darling, Chief Secretary to the Treasury from May 1997 to July 1998. Available from:
www.hm-treasury.gov.uk/newsroom_and_speeches/press/1998/press_84_98.cfm

[151] Per Stephen Byers, Chief Secretary. Available from: www.hm-treasury.gov.uk/newsroom_and_speeches/press/1998/press_126_98.cfm

2. The Introduction of the New Regime

The proposal for reform was one of the first announcements made by the newly elected government in 1997 and having announced the Labour party plan to overhaul market regulation, Gordon Brown, Chancellor of the Exchequer, set about justifying the radical and contemporary transformation that was to take place. The Chancellor observed that the regulatory system under the Financial Services Act 1986 was "not delivering the standard of supervision that the industry and the public have a right to expect."[152] The informal statutory framework had to make way for a more structured regime involving detailed rules and regulations. The need for a new regime was viewed as "logical" and "urgent."

a. Benefits of a Single Regulator

A central purpose of the reform was to create a regulatory framework that was apt to deal with the new fashion of integrated markets and financial conglomerates. However, the objectives were far more diverse than simply this and in two FSA Occasional Papers, Briault outlined the arguments in favour of a single regulator and the benefits it should bring.[153] The framework of law to be created by the FSAMA would be "modern and flexible," creating a single regulator which would best reflect the structure of the market and be better able to supervise financial conglomerates.

A single regulator would also bring economies of scale and scope in regulation. Economies of scale would arise due to the integrated management and service systems, and the removal of costly regulatory overlaps that occurred in the previous system. The Treasury's Regulatory Impact Assessment[154] noted that the efficiencies would be passed on to financial intermediaries through reduced compliance costs and fees. Firms that were

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[152] Brown, G. ibid, n.2

[153] Briault, C. (1999) The Rationale for a Single National Financial Services Regulator. *Financial Services Authority Occasional Paper*. No. 2. Available from: http://www.fsa.gov.uk/pubs/occpapers/op02.pdf

Briault, C. ibid, n.133

[154] HM Treasury. (1998) *Financial Services and Markets Bill: A Consultation Document Part Three. Regulatory Impact Assessment.* London, HM Treasury.

previously subject to regulation by more that one authority were promised savings in compliance costs, the result being that the new regime should "lead to savings for a significant proportion of authorised persons."[155] The introduction of a single complaints-handling scheme and a single compensation scheme to replace the "patchwork quilt of complaints resolution schemes"[156] that existed under the Financial Services Act would further reduce costs. With an overview of the whole system, a single authority should be better placed to distribute resources where they are most needed and to tackle cross-sector issues. The ultimate result of the improvements to efficiency and effectiveness of supervision would be the improved competitiveness of the UK financial sector in the global market.

From a consumer's perspective, a single authority would remove the confusion and complexities of the previous system, thus paving the way for increased confidence and understanding in financial services. The introduction of a single authority would also create a clear line of accountability, with no other bodies to whom it could 'pass the buck'.

Lomnicka concluded that all of these benefits together mean that the "Single regulator presents opportunities for developing a rational and coherent regulatory system."[157] The FSA would be "well placed to deliver effective, efficient and properly differentiated regulation in today's financial environment."[158] As both a cause of and response to market developments, regulation will always be most effective where it works in harmony with market forces.

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[155] Blair, C. (1999) Financial Services and Markets Bill. *Research Paper*. Available from: http://www.parliament.uk/commons/lib/research/rp99/rp99-068.pdf

[156] Liddell, H. IN: HM Treasury (1997) Available From: http://www.hm-Treasury.gov.uk/newsroom_and_speeches/press/1997/press_165_97.cfm

[157] Lomnicka, E.Z. (1999) Reforming the UK Financial Services Regulation: The Creation of a Single Regulator. *Journal of Business Law.* September, pp. 480-489

[158] Briault, C. (1999) ibid, n.153

In summary a single regulator would provide efficiencies in regulation through economies of scale and scope, it would be in the best position to resolve cross-sector conflicts, it should facilitate the removal of differentiation between products which is not longer appropriate due to market blurring, and it would provide for a more transparent and accountable system. A single regulator would also provide for a more simplistic regime that could be understood by all, this in turn would result in greater confidence and greater accountability.[159] Ultimately, the desire was to simplify market regulation by creating "a regulatory regime to meet the challenges of the twenty-first century."[160]

b. Mechanisms for Achieving the Objectives

The benefits outlined above are all very appealing, but a new regulatory system could not secure their achievement without further mechanisms to ensure their attainment. The FSAMA provides numerous methods for ensuring the continued accountability of the FSA.[161] Efficiency and effectiveness of the system should be ensured through the FSA's use of cost-benefit analysis. Thus meaning that the FSA must calculate to the best of its ability whether the expected benefits of a course of action will really outweigh the costs incurred.[162] The FSA is also committed to a system of "risk-based" regulation,[163] so that the levels of protection and supervision are dependant on the situation at hand.[164] Through these methods, the FSA should be able to avoid wasteful use of its limited resources, resulting in economic regulation. In

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[159] Llewellyn, D.T. (2000) ibid, n.1

[160] Brown, G. ibid, n.2

The benefits of adopting a single authority have been echoed by numerous authors ever since the reforms were first proposed.

[161] See above, A.2 Accountability of the FSA.

[162] Alfon, I. & Andrews, P. (1999) Cost-Benefit Analysis in Financial Regulation. *Financial Services Authority Occasional Paper*. No. 3.

Available from: http://www.fsa.gov.uk/pubs/occpapers/op03.pdf

[163] Financial Services Authority (2000) ibid, n.113

[164] For example more protection will be given where the client is less sophisticated, or there is an imbalance of power between the parties.

an effort to further reduce the complexities create by the old regime; the FSAMA introduced single compensation and complaints schemes.

3. Was the FSAMA the Only Solution?

a. A Single Authority

The Chancellor stated that the new regime was based on "sound economic principles,"[165] yet he failed to mention the details of these principles and at no point did he offer any suggestion of the economic assessment that had been undertaken. Alistair Darling[166] stated that, "the only answer" for reform was a single regulator, without so much as hinting at alternatives that may have been considered and dismissed. It is quite true that the discussion above, into the aims and objectives of the regime outlines many reasons for introducing a single regulator, but it does not take into account the negative aspects that must be put in the balance. The Government did not openly discuss whether an alternative structure could achieve the same anticipated results as a single regulator.

It is quite possible that the Opposition accepted the introduction of a single regulatory authority in principal because they had already accepted defeat on the matter.[167] However, it is widely thought that the Conservative government itself would have proposed the introduction of a single regulator if it had stayed in power, and the lack of objections to the Chancellor's proposal for a single regulator simply indicate that it was thought to be the best solution

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[165] Brown, G. ibid, n.2

[166] Ibid, n.150

[167] Ferran, E. (2003) Examining the UK's Experience in Adopting the Single Financial Regulator Model.

Available from: http://islandia.law.yale.edu/ccl/papers/symposium10-21-03/2-4Panel2Ferransingleregulator.pdf

by all involved. Howard Davies boldly stated that, "There was cross-party support throughout the process for the principle of a single regulator."[168]

Several concerns over the introduction of a single regulator were outlined in the House of Commons Research Paper.[169] Fear that a single regulator would lack clarity of focus, would apply a 'one-size-fits-all' approach to regulation and would involve an internal matrix-like structure, not to mention the costs involved in implementing the regime. The Paper also noted comments such as those in the Guardian, which suggested that a single regulator could become a "bureaucratic monster".

Numerous commentators have made more comprehensive studies of the potential drawbacks of a single regulator. The recent paper produced by the World Bank provides a largely impartial analysis of the pros and cons of an integrated financial regulatory system.[170] A significant drawback to which the paper draws attention is that during the transition period to any new regime the effectiveness of regulation will be reduced.[171]

It was advanced that the divisions within the financial market had individual characteristics that called for independent regulators in order to ensure effective regulation. In addition a single regulator has the potential to become excessively bureaucratic. It was also suggested that the benefits promoted by the introduction of a single regulator could be achieved through other, less drastic reforms.

While I am in no doubt that there is no perfect solution to the issue of regulation and there is no single structure which should be adopted by all; without understanding the full extent of Government research into the situation surrounding the previous system and the length of any examination of other possible reforms, how can one be sure that the FSAMA approach is the most desirable?

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[168] Davies, H. (2000) London Chamber of Commerce Conference. Available from: http://www.fsa.gov.uk/pubs/speeches/sp49.html

[169] Blair, C. (1999) ibid, n.155

[170] Rose, T.A. & de Luna Martínez, J. (2003) International Survey of Integrated Financial Sector Supervision. *World Bank Policy Research Working Paper.* 3096, July 2003.

Available from: http://econ.worldbank.org/files/28404_wps3096.pdf

[171] Although this is true for any change in regulatory structure and is largely dependant on the way in which the transfer is made.

b. Provisions of the FSAMA

Although the principle of introducing a single regulator was largely unchallenged, the same cannot be said about specific provisions of the Financial Services and Markets Bill ("FSAMB"). Having accepted that the introduction of a single regulator was inevitable, the Opposition launched an all out attack on individual provisions of the Bill, resulting in a somewhat difficult passage through Parliament. It was the subject of "200 hours of debate, more than 2,000 amendments and some high profile disputes."[172] Not to mention that it was defeated three times in the Upper House.[173]

The debates focused on two main issues, the fear that the FSA would be 'judge, jury and executioner,' and the level of accountability that would be secured in order to keep the FSA's vast powers in check. There were great worries that the new 'super-regulator' would operate largely unrestrained. However, as the brief discussion above shows, the FSA is subject to many controls and requirements that are designed to ensure its accountability.[174]

Alongside accountability issues were fears that there were insufficient measures to ensure the FSA was committed to efficient use of its resources. Again the Economic Secretary was quick to defend the regime, "the need to consult the practitioners' panel, and publication of the annual report, and the role of the non-executive directors in ensuring money is spent properly will prevent the Authority spending too much money… when the FSA imposes fees, it has to provide details of proposed expenditure."

The FSA's statutory immunity raised concerns by the Opposition, especially given that it is a private company limited by guarantee. The Economic Secretary silenced these objectors by stating that, "Without statutory immunity, the proper and efficient action of the regulator would be frustrated by law suits and red tape… it could lead to a tendency to over regulation." In addition the immunity was a necessary requirement in the ambit of banking regulation to comply with the Basle principles.

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[172] Davies, H. (2000) ibid, n.168

[173] The House of Lords.

[174] For further discussion see: Mistry, H.B. (2001) ibid, n.12

This brief analysis outlines merely a handful of the issues discussed in Parliament and offers just a brief insight into the numerous debates that the FSAMB provoked.[175]

C. REFLECTION ON THE FSAMA

In this section I would like to consider the key rationale and objectives[176] of financial regulation in general, before moving on to give a brief outline of the costs of regulation. The reader will then be in a better position to consider the success and failures of the FSAMA regime that follows later in the paper. In doing so, I will draw heavily on articles by Llewellyn[177] which give a clear and logical explanation of regulation. Regulation has its costs, both financial and social, and these must be taken into account when a regime is being proposed. I will briefly outline the fundamental costs of a regulatory system to highlight that such concerns must be considered.

1. The Rationale for Financial Market Regulation

Professor Gower once stated, "Regulation should be no greater than is necessary to protect reasonable people from being made fools of." Financial regulation has now become far more than this as consumers are more and more cautious about investing their money, but one must not forget that beneficial regulation has its limits; it is only economic to regulate up to the point before the costs outweigh the benefits. It would seem that this point has shifted along the scale so that greater levels of regulation are now more desirable and lest 'costly' to society.

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[175] Other topics for discussion included the content of the annual report, issues surrounding the individual objectives of the FSA, Treasury reviews, and the investigation powers of the FSA. Please refer to Hansard for text of the full discussions.

[176] Although the rationale and objectives are intrinsically linked, Llewellyn, D.T. (1999) emphasised that they must be considered as two separate issues.

[177] Llewellyn, D.T. (1999) The Case for Financial Regulation. *Journal of International Financial Markets*. Vol. 1 (4), pp. 153-161.

Llewellyn, D.T. (2000) ibid, n.1

Financial regulation exists in two forms, prudential supervision[178] and conduct of business regulation,[179] and hence it centres around two main objectives, the prevention of systemic risk and investor protection. In brief, systemic risk is the danger of the failure of financial intermediaries and that the financial market may collapse. A successful financial market necessitates stability and confidence; a market cannot enjoy new entrants and growth if it is surrounded in potential risk of collapse. Systemic risk is mostly associated with the banking sector, the phenomenon of 'bank runs' whereby the failure of one bank results in consumers withdrawing their money from all banks regardless of reputation or risk, comparable to a domino run. In support of this view one need only look to the collapse of BBC or Barings to see that confidence in the banking sector, as a whole, was not damaged. It is true that the likelihood of a complete market collapse is low, but the consequences would be so serious and so costly to the economy that sufficient regulation must be in place to prevent such occurrence.[180]

The second objective, investor protection, relates to the elimination of imperfections that exist in the market place. Such imperfections stem from the information asymmetries that are found in imperfectly competitive markets, which can result in fraud, negligence, conflicts of interest and the like. In such conditions it is far easier for sellers to exploit consumers.

Having established the objectives that provide the "theoretical underpinning" for regulation[181] one can then ascertain the economic rationale for regulation. First, as I have already discussed as an objective of regulation, the prevention of systemic risk. It is both economic and logical to impose a means for preventing market collapse.

Secondly, they're a number of rationales relating to the maximisation of consumer welfare and investor protection. The first of these is the correction

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[178] Prevention of systemic risk and market failure.

[179] This refers to the rules and guideline that govern the business activities and behaviour of firms. It's aim is protection against dishonesty, negligence and information asymmetries.

[180] Benston (2003) on the other hand disputes this idea as irrational on the part of the consumer.

[181] Davies, H. (1998) Why Regulate? Henry Thornton Business Lecture. City University Business School, London.

Available from: http://www.fsa.gov.uk/pubs/speeches/sp19.html

of market imperfections, which ultimately mean costs for the consumer. Regulation is justified in order to remove the problems of information asymmetries that mean that the consumer cannot easily compare products and make informed choices. Examples include difficulties in ascertaining the quality or appropriateness of any given product. By forcing firms to disclose a minimum standard of information the public are able to make better decisions and rest assured that they have made those decisions on the basis of valid information and not merely on assumptions. Linked to this is the problem known as "Lemons and Confidence", by this we mean that where a consumer has sufficient awareness to know that there are both good and bad products or firms in the market but they lack the knowledge to distinguish them, they may chose to leave the market altogether rather than risk choosing a bad option.

One of the rationales put forward by Llewellyn is that regulation can in fact increase the competition level in the market. By equipping consumers with greater knowledge they will be more able to switch to other firms, firms will have to compete for consumers who won't simply make a selection based on perceived reputation of the firm. Consequently competition will become more effective in the market place and prices may be driven down.

Aside from the market imperfects that justify regulation, there is a simple motive based on efficiency and economies of scale. By delegating the task of monitoring to an authority, consumers will reduce their overall transaction costs, not only financial but also with regard to time and effort. In addition consumers demand regulation because they are aware of the imperfections in the market.

"Regulation is crucial to successful development of financial sectors… there is clear evidence that financial systems are better developed… in countries with strong investor protection."[182] Given that consumers demand regulation it is therefore rationale to supply it. However, there is a limit to how much regulation is rational and consumers will only be conscious of this is they know that regulation comes at a cost. After all it is ultimately the consumer who pays for the costs of regulation, and no amount of regulation can replace the exercise of adequate care and attention by consumers themselves when purchasing products.

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[182] Mayer, C. (2000) Regulatory Principles and the Financial Services and Markets Act. IN: Ferren, E. & Goodhart, C. eds. (2001) *Regulating Financial Services and Markets in the Twenty First Century.* Oxford, Hart Publishing.

2. The Costs of Regulation

At a basic level, the costs of regulation can be divided into three types; direct costs, indirect costs and distortion costs.[183] Direct costs refer to the costs involved in paying for a market regulator. This may include things such as the costs of employing people, purchasing necessary equipment and premises and also the costs of producing rulebooks, guidance and legislation etc. There will also be the expense of creating a compensation fund, which would be funded by the intermediaries acting on the market. Indirect cost is the increase in costs resulting from the requirement of compliance with any regulations imposed. Distortion costs is the term used to describe any costs that arise from changes in the market due to regulation. It is these costs with which we are most concerned. If the distortion costs outweigh the benefits gained by regulation then, taken as a whole, the regime is unbeneficial.

In addition to all of this expenditure, a poor regulatory regime has several other potential costs. First, diversion of resources. The fact that additional resources are needed to comply with regulatory requirements may result in firms moving their business to a market in another country where costs are lower. If a firm decides that it would be more profitable to deal elsewhere then it may chose to remove all business from the current market. Should it arise on a large scale, the market could see the removal of all providers for a given product or even the collapse of the whole market. True, this is in the extreme but if the market cannot attract firms it cannot grow and competition will be stifled. The result of this *static inefficiency* would be that consumers would have to pay higher prices than in a competitive market, hence the market would not satisfy an optimum level of consumer welfare.

Other consequences of over-regulation include the 'moral hazard' of firms acting in a risky manner in the knowledge that a safety net exists such as a lender of last resort. Alcock (2003) describes this cost as "infantilisation… treat people like children and they will behave like them."[184] Haldane and

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[183] Briault, C. (2003) The Costs of Financial Regulation. ZEW/AEI Conference on Regulation and Supervision of Financial Markets and Institutions in the EU. Available from: www.fsa.gov.uk/pubs/speeches/sp140.html

[184] Alcock, A. (2003) Are Financial Services Over-Regulated? *Company Lawyer*. Vol. 24(5), pp. 132-138.

Taylor[185] recently confirmed that, having looked at the evidence; moral hazard remains a concern in today's economy.

A regulatory regime must not be such that the distortion costs outweigh the benefits, it must not entail such indirect costs that firms will opt to trade on other markets instead, and it must not hinder diversity and market innovation. The consequences of regulation aren't always limited to those intended and it is important that both the regulators and regulated are aware of this fact. After all the ramifications from over-regulation can be far worse than the costs of imperfect market conditions.[186]

3. The Success of the FSAMA

a. Achievement of the Objectives

The discussion in the previous section identifies many of the motives for the reform and many of the Governments objectives for the new scheme, but as yet we have not considered whether these aims have been satisfied. It is all well and good to establish a legitimate set of goals but if they are not met what has been accomplished?

The introduction of the FSAMA, as with any regulatory reform, has not been without cost to the system. The success of the FSAMA can only be determined by considering these costs against the benefits that have arisen; regulation is only worthwhile where the results achieved are better than those under an imperfect, free market system. As Davies said, "The cure must not be worse than the disease."[187] The question here is whether the UK has managed to achieve this and if not, where has it fallen short? It doesn't matter how low the costs are if the aims and objectives are not being met.

One of the key Government objectives of the reform was to improve efficiency in regulation by creating economies of scale and scope. Although we cannot be sure of the exact costs of the implementation of the FSAMA regime,

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[185] Haldane, A. & Taylor, A. (2002) Moral Hazard: How Does IMF Lending Affect Debtor and Creditor Incentives? *Financial Stability Review*. Vol. 14, pp. 122-133.

[186] Mayer, C. (2000) ibid, n.182

[187] Davies, H. (1998) ibid, n.181

the Annual Budgets produced do provide an overview of costs currently involved. In the latest Business Plan, Paul Boyle, Chief Operating Officer of the FSA, stated that, "Inn the first three full years since the FSA assumed its full powers its costs will have increased by no more than inflation." [188] However, this somewhat disguises the fact that in 2003/04 the net cost was "slightly higher in real terms" than the year before.[189] So we know that the costs are stable, but not whether they are at their lowest possible. Before his departure last year, Howard Davies stated his belief that the FSA had scope to further increase its efficiency.

Another closely linked aim was effective regulation i.e. achievement of the objectives of regulation. The new Chairman, Callum McCarthy, stated in the Business Plan 2004/05 that there was "considerable scope for making the FSA itself a more effective organisation." Couple this with the need to introduce a new management structure in April 2004 and it is clear that the FSA has not yet achieved an adequate level of effective regulation.

Consumer education is one area in which the FSA is unquestionably underachieving; it has as much as admitted that itself. The FSA has produced a vast array of material but according to Davies, "readership is not yet wide enough." Whatever the cause of this, it is the FSA's responsibility to ensure that it is educating consumers in the risks involved in financial products.

The FSA would also appear to underachieving in terms of educating regulated firms. A much talked about complaint of the FSA is the 'inaccessibility of the FSA Handbook.' On many occasions commentators have remarked on the complex language used and the relentless alteration of the provisions.

On the issue of accountability, there are two clear and strong lines of argument. First, it has been contended that the structure of overlapping regulatory authorities that existed under the FSA 1986 provided a system of checks and balances and ensured that each was accountable for its actions. In contrast, Mistry[190] puts forward the view that with a single authority no one

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[188] Financial Services Authority. (2004) Business Plan 2004/05, *FSA Plans & Budgets Publication.* London, Financial Services Authority.

[189] The increase was justified as a result of the new responsibilities it had assumed and Boyle stated the cost of the new tasks was offset by improvements to efficiency which had resulted in saving of £8.6m.

[190] Mistry, H.B. (2001) ibid, n.12

can "pass the buck" and hence they must accept responsibility for their own actions and shortcomings. The creation of a clear of separation of powers between the regulatory authority and the Treasury mean that the level of accountability has not been affected.[191] In fact Mistry goes as far as to say that, given the means of parliamentary control that now exist,[192] the FSA is actually subject to more controls than the previous authorities.[193]

b. Current Opinions

Opinions of the FSAMA remain somewhat mixed; there is a clear divide between those in favour of the FSA, who are willing to accept that any new regime will need time before it is fully achieving and those who did not agree with the introduction of the single regulator and who remain unconvinced after more than two years.

In its first year, the FSA received a large amount of complaints, the majority of which came from consumers. The Independent even suggested that "Hardly anyone has a good word to say about the regulator," but the number of complaints has gradually declined as the FSA has adapted its approach.

With a responsibility to both consumers and practitioners, the FSA has a difficult regulatory balance to find. In the Annual Public Meeting last year, Davies asserted that the FSA has strong support from regulated firms and in a recent article, Ferran supported this view, "the FSA regime has broadly retained the confidence of both the industry and consumer associations."[194] However Sheila McKecknie, Head of the Consumers Association, has not been convinced, she believes that the FSA cannot succeed due to its duel role to protect consumers and maintain market stability; "One regulator performing this role does not work." In addition she said that the "FSA does not give

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[191] at page 247

[192] Parliamentary control through the Treasury, for example by appointing the executive board, the requirement of the FSA to produce an annual report for the Treasury and the statutory power of investigation that the Treasury has.

[193] at page 248

[194] Ferran, E. (2003) ibid, n.167

sufficient weight to consumers interests and fails to "understand that competition doesn't always work in the consumers favour."[195]

Before his departure last year, Howard Davies assured us that "The new Act is working well." He remained convinced that the introduction of a single regulator under the FSAMA was the right decision. While the FSA continues to have a positive view of itself, there remain many sceptics who need solid proof before they will be willing to change their opinions of the FSAMA regime.

Alcock has been particularly vocal with his opinion that the FSAMA was "overreaching and ambitious."[196] Prior to the introduction of the new regime, Alcock alerted us to the risk that the FSA would impose "an inappropriately high level of relatively standardised regulations on the whole financial services sector." In addition he was concerned that with such a vast array of areas under its control, the board of the FSA would lack the expertise required to adequately supervise the markets.[197] Soon after the introduction of the FSAMA, Alcock remained unconvinced by the new regime. He spoke of his support for the prominent argument that the FSA is overburdened by its numerous tasks as the single regulator, and consequently it cannot focus on all of its tasks.[198] However, more recently he has accepted that the FSA regime does in fact provide some safeguard against the risk of over regulation.[199]

Sarker poses as another critic of the FSA, with the opinion that the FSA has the "potential to become bureaucratic and unfocused."[200] While the clearly defined objectives have been designed to ensure that the FSA continues to be focused, the FSA has itself demonstrated the bureaucracy that was feared.

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[195] Quoted in: Knight, J. (2003) McCarthy's Challenge, *BBC New Online Article.*

[196] Alcock, A. (2000) The Financial Services and Markets Act 2000: A Guide to the New Law. London, Jordan Publishing Ltd.

[197] Alcock, A. (1998) A Regulatory Monster. *Journal of Business Law.* Vol. No. 7, 371-379.

[198] Alcock, A. (2002) FSMA – The First Six Months' Check-up. *New Law Journal.* Vol. 152 Issue 7036, 921.

[199] Alcock, A. (2003) ibid, n.184

[200] Sarker, R.L. (1998) ibid, n.144

Although other concerns may have subsided over the past two years, concerns over the independence of the FOS and the Consumer and Practitioner Panels remain strong.[201] The fear is that if the boards of these bodies are appointed by the FSA they cannot be independent and thus cannot adequately provide impartial advice to the FSA. The FSA remains adamant that both bodies are independent and that they both exercise significant influence over FSA decisions.

It is the job of the FSA and its associate bodies to prove these disbeliveers wrong; the only way will be through maintaining a stable market with minimal failure and increased investment, alongside successful attainment of all the statutory objectives.

The FSAMA has been fully in force for just over 2 years now, but firm conclusions on the success of the new regime have yet to be offered. The general consensus appears to be that it is still too early to reach firm conclusions on the success of the FSAMA.[202] As Ferran stated "[the new regime] is still in its infancy, although there are certainly many positive signs."[203] While most are forgiving of mistakes that the FSA has made during its initial years, it is unlikely that people will continue excuse slip-ups in the future.

The FSAMA is unquestionably an attempt to reflect the realties of the modern financial market but if the market continues to evolve in light of contemporary trends and technological developments it is possible that in a few years the FSAMA will itself be out dated and reform will once again be long overdue.

One thing that we can be sure of it that the introduction of the new regime has already required amendments on numerous occasions. With regard to the FSA Board, last year we saw the combined role of the chief executive and chairman split into two and in April this year the management structure of the FSA will again be reorganised to put the FSA "in the best possible

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[201] See the FSA Annual Meeting 2003 questions for examples.

[202] See Ferran, Mwenda and others.

[203] Ferran, E. (2003) ibid, n.167

position" to achieve its objectives. If the creation of new secondary legislation and consultation documents does not diminish, the FSA will certainly have lived up to the expectations of its critics by becoming "a bureaucratic monster."[204]

Many, including Gordon Brown, have attributed their perceived success of the FSA to the work of Howard Davies; "That the FSA is now widely acknowledges as a world leader in its field is largely thanks to Sir Howard's drive and vision." What does this mean for the future of the FSA? Can McCarthy and Tiner live up to the reputation of their predecessor?[205]

With the imminent extension of FSA powers to incorporate mortgage lending and general insurance, the FSA will soon be responsible for more than double the number of firms that it is as present. Whether the FSA can provide efficient and effective regulation remains to be seen.

c. The FSAMA Under Review

In November 2003 Ruth Kelly, Financial Secretary to the Treasury announced that a review of the FSAMA was to begin. Included in the review are examinations of the FSA handbook, frequently criticised for its complexity, the lack of guidance provided for small firms and the abundance of consultation documents produced by the FSA. A review of the Ombudsman Service will look at how it has interacted with the regulatory responsibilities of the FSA and consider possible alterations to the process of appeal. In addition, the Office of Fair Trading will be studying the effect that the FSAMA has had on competition in the financial market. The FSA itself will be conducting a review of its failure to educate the public on financial service issues.

Much of the criticisms of the regime have subsided over the past two years, but I have no doubt that the release of the report will trigger an abundance of opinions and discussions on the success and failures of the UK's

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[204] In its first year alone, the FSA issued over 250 documents including some 38 consultations. The costs of such publications can only be imagined but it must equate to a significant sum.

[205] Shortly after his appointment was announced, McCarthy voiced strong ideas for changes he would be making at the FSA.

financial regulatory system. Until that time we must simply hope that the FSA is mature enough to have begun learning form its early mistakes.

D. LESSONS TO BE LEARNT FROM THE UK'S EXPERIENCE

The UK was by no means the first country to adopt a single market regulator[206] but it has unquestionably provoked the most amount of discussion. One could easily look to the experiences of the Scandinavian countries for lessons on the introduction of a single regulator, but as Europe's major financial centre, the UK has been the focal point. With each country adopting a slight variant of the single authority model, the UK is the only country that appears to have gone the 'full hog' to integrated regulation.

For countries considering a reform along the lines of the UK and Scandinavian countries, many things must be contemplated, whether a single regulator is the right approach will vary from country to country. The decision-tree in Appendix 3 provides a superficial method for making a preliminary decision on whether or not it would be beneficial to adopt a single regulator in any given country. However, an in-depth evaluation of the country's current and future circumstances must be taken into account before any legitimate decisions can be made. Llewellyn outlines five key factors for determining the regulatory structure:

- Evolution of the market.
- Financial market structure.
- Political structure.
- Size of the country and its financial market.
- Country specific aspects.[207]

Consideration of the precise structure of the proposed regulator must then be made, for example insuring independence and accountability, removing any conflicts of interest and ensuring effective cooperation across the authorities.[208] Introducing a single regulator must not be seen as an easy

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[206] At the end of 2002 almost 50 countries had adopted a system of integrated financial market supervision.

[207] Llewellyn, D. (1999) ibid, n.177

[208] Llewellyn, D. (1999) ibid, n.177

solution to supervisory problems; what works in one economy may be the downfall of another. A genuine assessment of the possible problems must also be made before deciding on the correct path to take. If such problems are not properly considered the regime can be sure to fail. But one thing that can be said for all countries considering reform is that the swift and all-encompassing approach to the changeover taken in the UK drastically eased any confusion that may have arisen during the transition period.

In light of current discussion over the creation of a single European financial market, it would seem that the UK might be in for another regulatory upheaval. It remains to be seen if the UK system will be used as a model for Europe. One thing we can be certain of is that the new regime has not put an end to the financial scandals that can rock the economy. Under the FSA's supervision we have encountered the Equitable Life saga and endowment mortgages and split-capital investment trusts mis-sellings.[209] The case of BCCI Liquidators v. Bank of England has finally come to court and the FSA must wait to see if the floodgates will be opened for claims against market regulators.

[209] Although the FSA was cleared of fault in the Equitable Life case, it did not prevent renewed nervousness in the City.

APPENDIX 1 - REGULATED ACTIVITIES & EXCLUSIONS

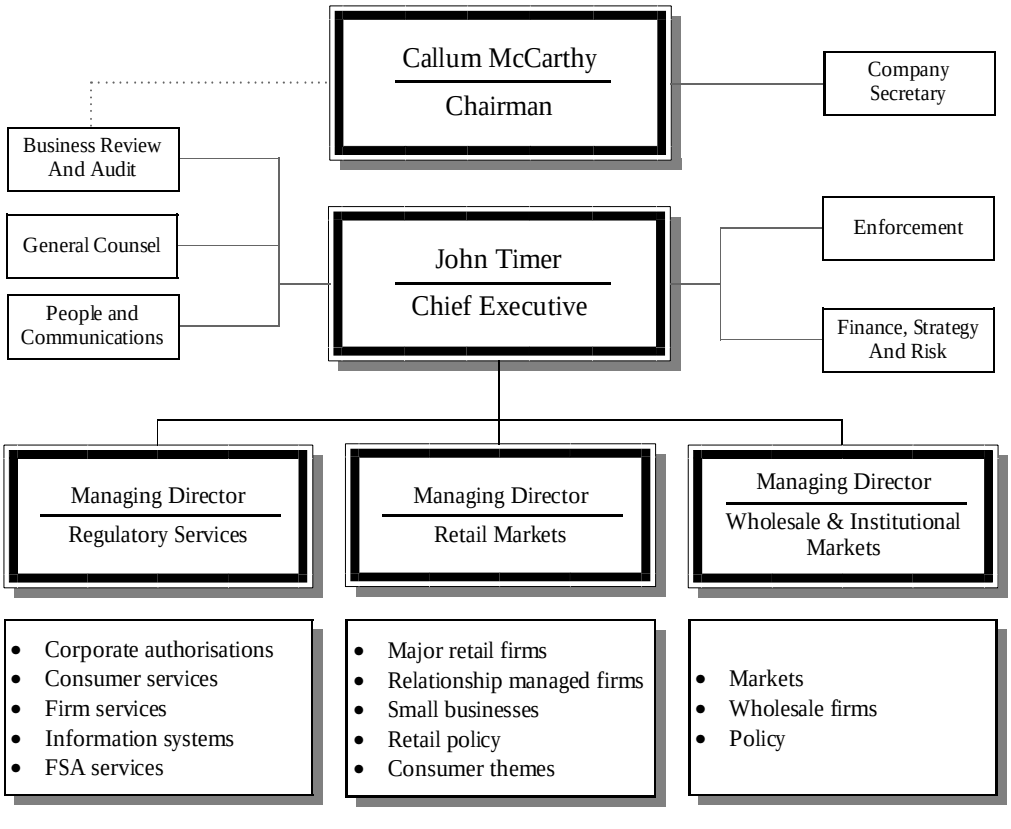
Specified regulated activities and exclusions contained in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

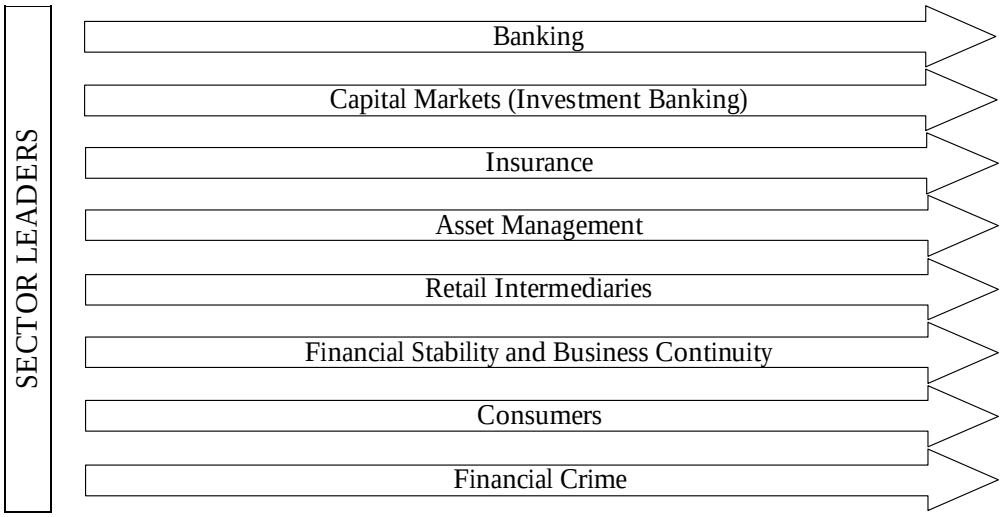
Regulated Activity	Specified Exclusions
Accepting Deposits Provided that the money received via the deposit is lent to others or it is used to finance an activity of the person accepting the deposit.	Sums paid by certain persons Sums received by solicitors etc. Sums received by persons authorised to deal etc. Sums received in consideration for the issue of debt securities
Effecting & Carrying Out Contracts of Insurance	Community co-insurers Breakdown insurance
Dealing in Investments as Principal	Absence of holding out etc. Dealing in contractually based investments Acceptance of instruments creating or acknowledging indebtedness Issue by company of its own shares etc. Risk management
Dealing in Investments as Agent	Deals with or through authorised persons Risk management
Arranging Deals in Investments	Arrangements not causing a deal Enabling parties to communicate Arranging transactions to which the arranger is a party Arranging deals with or through authorised persons Arranging transactions in connection with lending on the security of insurance policies Arranging the acceptance of debentures in connection with loans Provision of finance Introducing

	Arrangements for the issue of shares etc. International securities self-regulating organisations
Managing Investments	Attorneys
Safeguarding & Administering Investments	Acceptance of responsibility by third party Introduction to qualifying custodians Activities not constituting administration
Sending Dematerialised Instructions	Instructions on behalf of participating issuers Instructions on behalf of settlement banks Instructions in connection with takeover offers Instructions in the course of providing a network
Collective Investment Schemes	
Establishing etc. a stakeholder pension scheme	
Advising on Investments	Advice given to newspapers etc.
Advice on syndicate participation at Lloyd's Managing the underwriting capacity of a Lloyd's syndicate Arranging deals in contracts of insurance written at Lloyd's	
Funeral Plan Contracts	Plans covered by insurance or trust arrangements
Regulated Mortgage Contracts	Arranging administration by authorised person Administration pursuant to agreement with authorised person
Agreeing to carry on specified kinds of activity	Overseas persons

NB. Due to the numerous amendments to the Regulated Activities Order, this table is by no means exhaustive.

APPENDIX 2 - FSA MANAGEMENT STRUCTURE, APRIL 2004

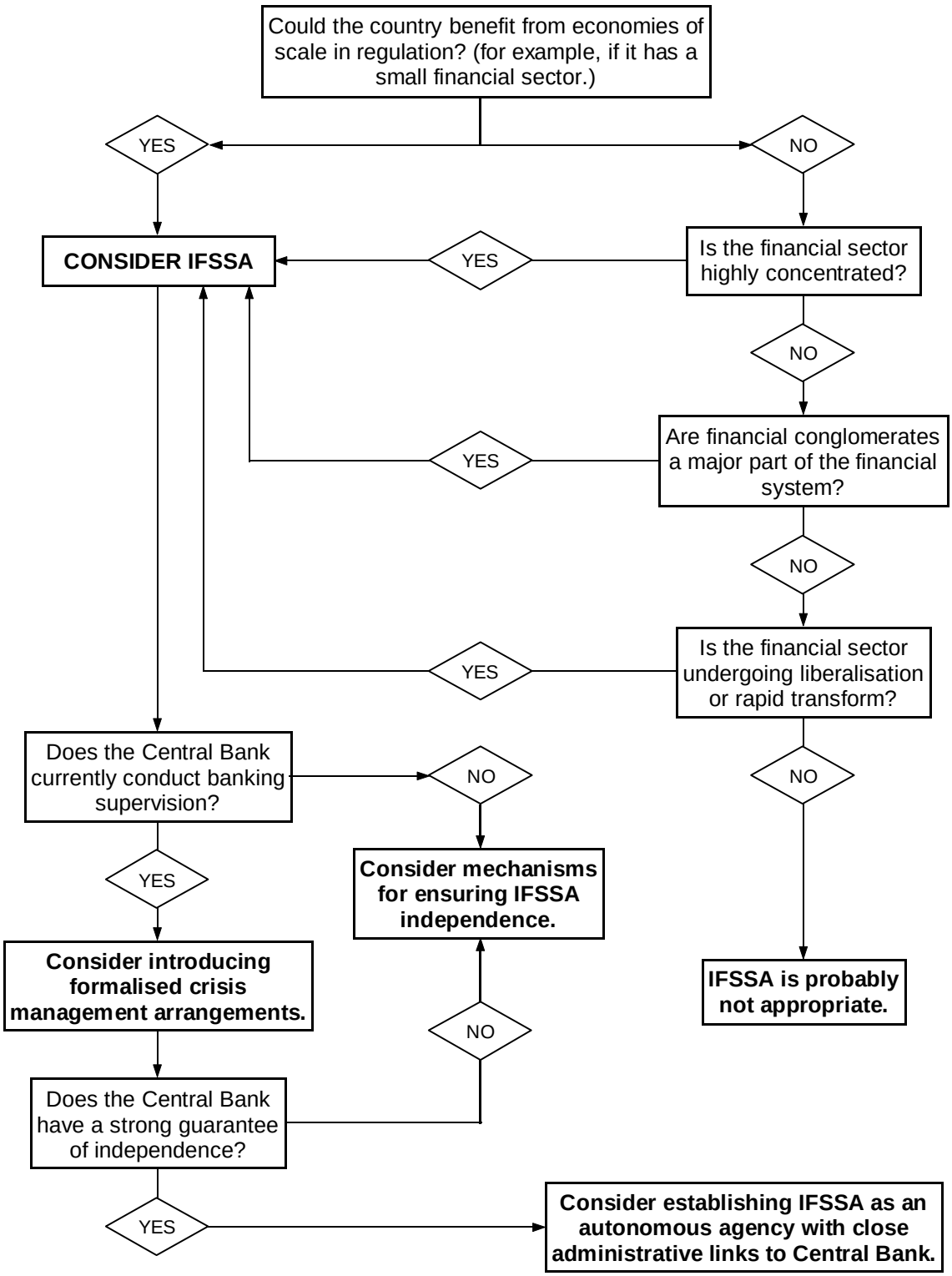




Role of Sector Leaders:

- Ensure that issues relevant to their sector which pose risks to the FSA's objectives are identified and resolved
- Ensure the FSA is developing the depth and breadth of sector-specific expertise among its people
- Represent the FSA in its dealings with the wide range of external parties concerning their sector.

APPENDIX 3 - INTEGRATED SUPERVISION DECISION TREE



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