



**The Financial Conduct Authority: Approach to Regulation (June 2011)**

**A response paper by the Futures and Options Association**

**SEPTEMBER 2011**

## The Financial Conduct Authority: Approach to Regulation

### 1. Introduction

- 1.1 The FOA is the industry association for more than 160 firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector (see Appendix 1).
- 1.2 In general terms, the FOA broadly supports the revised approach to business conduct and regulatory policy set out in FSA's Discussion Paper ("DP"), subject, however, to the principles of proportionality, balance and fairness and the other points set out in this response.
- 1.3 The FOA supports the policy approach of the FSA as set out in para 1.11 in the DP, but is concerned that, in describing the regulatory policy of the FCA, no real attention or recognition appears to have been given to the Government's observations about regulatory burden or impact as set out in HM Treasury's Consultation Paper "A new approach to financial regulation: building a stronger system" (Cm8012), namely:
  - (a) that a key priority will be *"reducing the burden of regulation and improving the quality of regulation"* (paras 3.66-7);
  - (b) that policy-makers must *"think carefully about the case for regulation"*, and where intervention is required, to explore in full the opportunity for non-regulatory and self-regulatory approaches before considering regulatory measures (paras 3.66-7);
  - (c) that the new regulators must be *"rigorous in their analysis of the impact of regulation on industry"* (para 3.67);
  - (d) that it will be part of the FCA's role to remove regulatory barriers, where possible, to facilitate greater efficiency and choice and that this is *"clearly an issue of primary importance along the whole financial value chain and for all consumers of financial services"* (paras 4.15);
  - (e) that regard should be paid to the *"potentially negative effects of excessive regulation on market efficiency and consumer choice"* (para 4.9); and
  - (f) that the new infrastructure must be able to operate in a way that delivers coherence, efficiency, effectiveness and *"the best value-for-money solution for the financial services sector"* ("A new approach to financial regulation: judgement, focus and stability" (Cm7874)).

We see a mismatch between HM Government focussing strongly on the need for a "value-for-money" proposition and avoidance of excessive regulation, and the FSA, in describing the policy approach and functions of the FCA, seemingly giving these aspects of regulatory proportionality very little priority in the DP.

- 1.4 In addition to the comments in para 1.3 above, the FOA would summarise the points made in this paper as follows:
- (a) The FOA strongly supports the six principles of good regulation set out in the draft Bill and FCA's intention to be transparent to external stakeholders (see further para 3.1 in this response)
  - (b) The FOA supports the FCA's new role of promoting competition, but continues to question why, in view of the significant increase in commercial interventionism that is being afforded to the FCA and the potential consequences for firms, the importance of them being able to sustain their competitiveness is not a factor that will continue to be taken into account (see further para 2.1 in this response)
  - (c) The FOA welcomes the FSA's recognition that there are key differences between wholesale and retail markets and that financially sophisticated customers do not require the same degree of protection as retail consumers, as set out in paras 3.5 and 3.6 in the DP, but is concerned that there may still be some retail scope-creep into the regulation of wholesale business (see further para 3.2 in this response)
  - (d) The FOA is supportive of product intervention that is proportionate and founded on real and evidenced risk of "*significant*" consumer detriment, but does not agree that it is justified where there is risk of mis-selling, i.e. the quality of a product should be divorced from how it is sold (see further para 4.2 in this response)
  - (e) In the area of enforcement and credible deterrence, the FOA supports the need for a more effective approach, but one which also recognises the need for fair treatment of firms, proportionality in sanctions and recognition of the right of firms and individuals to be able to reasonably predict the consequences of their actions (see further paras 4.3 and 4.4 in this response)
  - (f) The FOA supports the fact that complaints against the FCA will continue to be handled by the Complaints Commissioner, but notes that this DP, in setting out the policy approach of the FCA, makes no mention of this fact, notwithstanding that it will be a key discipline on the decision-making process of the FCA (see further para 4.6 in this response)
  - (g) The FOA supports the intention that the FCA will be a risk-based regulator, and the assurance that oversight and supervision of what are very differentiated regulated firms will be tailored to the business plan, products, services and risk appetite of each firm (see further paras 5.2 and 5.3 in this response)
  - (h) While the FOA understands the strong consumer focus of FSA's new approach to business conduct regulation, it is so pervasive through the whole of the DP as to sustain concerns, despite Government assurances, that a proper balance might not be preserved as between the interests of consumers and regulated service providers (e.g. the FOA notes that most of the "*justification offsets*" are cited in relation to conflicting interests between consumers, and rarely makes any mention of the conflicting interests between consumers and providers)

- (i) The significant increase in the powers of intervention to be afforded to the FCA carries high risk of reputational and commercial loss for firms and suggests that it would be appropriate to review the current scope of statutory immunity to ensure that it continues to strike an appropriate balance between enabling the FCA to perform its regulatory role free of spurious threats of legal action and preserving the essential right of firms to seek legal redress for damages as a result of negligent or reckless decisions or actions
- (j) The FOA supports the statement that *“the design of the FCA will need to be framed in an EU and international context”* (para 1.7 in the DP), which, in the light of recent post-crisis changes in the EU regulatory infrastructure, will be critically important.

## **2. Scope**

- 2.1 The FOA notes the FSA’s recognition of the fact that FCA-regulated firms have *“a significant share of the global market in wholesale investment, insurance and banking sectors”* (para 2.5 in the DP), but seems to articulate this solely in the context of explaining, as it is put in para 2.6 in the DP, why its *“responsibilities would be very wide-ranging”*. While that is true, it also demonstrates precisely why competitiveness of firms needs to be taken into account and why it is in the interests of UK plc that they must continue to be internationally competitive. It is unfortunate that this is not recognised in the DP and emphasises the need for this to be one of the statutory regulatory principles in the draft Bill.

## **3. Objectives and Powers**

- 3.1 The FOA strongly supports the six statutory regulatory principles set out in para 3.3 in the DP and believes that the requirements of openness and transparency are critical to enabling regulated firms and their customers to be able to predict how the FCA will exercise its judgement in responding to the behaviours, services and products, and not just, as it is put in the DP, as a means of generating *“improved consumer outcomes”* (para 1.15). More particular, the FOA notes FSA assurances that the FCA *“will be transparent to external stakeholders* (para 1.15 in the DP) and that transparency *“will be a key element in the FCA’s regulation”* (para 4.16 in the DP).
- 3.2 With regard to wholesale business, the FOA welcomes the FSA’s assurances that the FCA:
  - (a) will *“recognise that there are important differences between wholesale and retail markets”* (para 3.5 in the DP); and
  - (b) *“will adopt a differentiated approach to protecting different categories of consumers”* (and supports the key considerations set out in para 3.8 in the DP), recognising that *“financially sophisticated consumers do not require the same degree of protection as retail consumers”* (para 3.6 in the DP).

The FOA notes the strength with which this differentiation is addressed in HM Treasury's Consultation Paper "A new approach to financial regulation: the blueprint for reform" (Cm8083), namely:

*"There are wholesale and market activities which do not directly form part of the transaction chain of products and services sold to retail customers. The scale and importance of these activities makes it imperative that they are effectively and proportionately regulated in a way which recognises the particular characteristics of participants in these markets"* (para 1.39).

The FOA understands FSA's concern over the capability of wholesale markets to impact retail markets and that, as a result, it will be focussing more closely on wholesale conduct and monitoring wholesale business behaviours (paras 1.10 and 5.27). However, this should not lead to any significant undermining of the assurances set out above, or the intention that the consumer protection objective be set at an "appropriate" level, taking into account the nature of the consumer.

- 3.3 The FOA supports the proposition that a key way to promote "good outcomes for retail consumers" is to equip them with the necessary information to facilitate a risk/performance assessment. However, it is equally important that the provision of information to consumers is not so "overloaded" as to go unread or impose an unrealistic burden on firms in terms of ensuring that information provided to consumers is kept up-to-date on a continuous basis.

At the other end of the scale, the FOA is supportive of the FCA undertaking a more proactive role itself in the provision of information to consumers and engaging directly with retail consumers to explain "what they can expect from the regulated firm and from the FCA itself" in the context of consumers taking "responsibility for their own decisions" (para 3.11 in the DP).

- 3.4 The FOA supports the FCA's intention to "focus more directly than the FSA has done on the workings of markets, including market power" and that this "will be an important change of emphasis in the new regulatory regime" (para 3.14 in the DP).

The FOA notes that, while it is not intended that the FCA should become an economic regulator in the sense of prescribing returns for financial products or services, the focus on competition will result in a number of outcomes, namely:

- (a) Pricing oversight because, as it is put in Box 2, "prices and margins can be key indicators of whether a market is competitive"
- (b) "Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers" – but not just to protect consumers, but also other "stakeholders" in the marketplace (e.g. regulated firms and competing infrastructures). Price intervention may also help to fulfil the market objectives of the FCA by addressing some of the factors that impact on those objectives, e.g. pricing of execution and clearing services, licenses and market data

- (c) The FCA developing a “*sound economic understanding of the way relevant markets operate*” to enable it to better act in the interests of competition
  - (d) The adoption of powers and measures in order to “*reduce market power*” (Box 2) (e.g. rights of clearing access)
  - (e) The power to initiate enhanced referrals to the OFT where the FCA has identified a possible competition issue that may arise from a specific structural market feature or from an anti-competitive business practice.
- 3.5 The FOA notes the emphasis on the role of the FCA in monitoring the soundness and resilience of the trading infrastructure and maintaining the integrity of financial markets in para 3.17 in the DP, but would emphasise the importance of establishing the same degree of information-sharing and co-operation with the Bank of England in relation to CCPs, as is envisaged existing between the PRA and the FCA in relation to the regulation of systemically-important institutions (see also para 6.1 in this response).

#### **4. Regulatory Approach**

- 4.1 The FOA notes the Government expectation that the FCA will intervene more strongly in “*retail financial services markets*”.
- 4.2 In relation to product intervention, the FOA has already responded to the Discussion Paper “Product Intervention” (DP11/1) issued by the FSA earlier this year, but would emphasise that:
- (a) it should only be exercised where there is a real and demonstrable risk of “*significant consumer detriment*” as demonstrated by the examples given in the DP of major retail consumer detriment in Chapter 5, insofar as they represent large-scale losses, indicating that the scale of anticipated detriment will be key to justifying use of the FCA’s product intervention powers;
  - (b) it should “*strike the right balance between consumer protection... and the risks of restricting consumer choice and product innovation*” (para 1.24);
  - (c) its exercise should be subject to safeguards to ensure due consideration is given to conflicting public policy interests, i.e. that “*an appropriate balance is struck between the interests of consumers and regulated firms*” (para 4.76);
  - (d) it should be exercisable only in accordance with clear and transparent policy criteria to enable firms to have a reasonable degree of certainty over the regulatory position as regards the development of new products;
  - (e) it should not become, as it is put in a previous HM Treasury consultation paper on regulatory restructuring, “*a substitute for regulation of the sales process*”, i.e. when a product is sold it is a business conduct, not a product quality, issue, yet FSA continues to state that one justification for banning a product could be the level of perceived risk of mis-selling;

- (f) the power of product intervention is *“unlikely to be appropriate in relation to professional wholesale consumers”* (HM Treasury’s Cm8012), although it is noted that it will remain an option where *“wholesale products filter down or are distributed to retail consumers”* (para 5.26); and
  - (g) while the FCA has no intention of approving financial service products or guaranteeing their return, this is nevertheless how its product intervention policy might be perceived by consumers and, as it is put by the FSA in para 3.26, this is a message that must be addressed with consumers *“effectively from the outset”*.
- 4.3 In relation to credible deterrence (paras 4.13-15), the FOA would repeat its observations that there needs to be clear and transparent criteria which set out clearly how the conflicts between FSA’s understandable wish to have credible deterrence, ensuring that the punishment fits the crime and that regulated institutions and senior managers are capable of predicting the consequences of their actions will be addressed.
- 4.4 With regard to the issuance of warning notices, the FOA welcomes the FSA’s acknowledgement in para 4.15 of the need to *“balance the advantages of openness with the need to respect private rights and due process”* and *“consult the person concerned before issuing any information about the warning notice”*.

Safeguards should include an obligation on the FCA:

- (a) to take into full consideration comments made by a subject firm when determining whether or not to issue such a notice and, as may be appropriate, on the wording of any such notice;
  - (b) to set out in the notice the defence of a subject firm to the allegation in question, recognising:
    - that there has been no finding of guilt;
    - that there is an overriding obligation on FCA to be fair in making public disclosures of this nature; and
    - that there is a high duty of care placed upon the FCA in exercising this power, bearing in mind that it is protected by statutory immunity, no matter how much reputational damage may have be caused to a subject firm and no matter how inadequate the evidence founding the allegation in question.
- 4.5 With regard to accountability, the FOA supports the elements set out in para 4.17, but believes that the proposal for a review of the economy, efficiency and effectiveness of the FCA by *“an independent person”* should include the matters set out in para 5.12, particularly the effectiveness of the FCA’s use of market and cost/benefit analysis, and the extent to which the six principles have been taken into account in the fulfilling of its objectives.
- 4.6 FOA notes the assurance in para 4.18 that firms will be able to appeal regulatory decisions, but would point out that part of the process of assuring the quality of those

regulatory decisions is reinforced by firms' rights of complaint to the Complaints Commissioner.

In this context, the FOA would point out that the role of the Complaints Commissioner is to investigate complaints about the way the FSA has carried out, or failed to carry out, its role and, as such, provides a system of checks and balances for its stakeholders – yet no reference is made to the role of the Complaints Commissioner throughout the DP.

## **5. Regulatory Activities**

5.1 While it is recognised that high-quality and timely information-gathering and business analysis will be critical to the success of the FCA, it is equally important that the FCA has the capability and expertise of undertaking comprehensive data analysis. The risk of information overload is very real, and weak data analysis will result inevitably in some incorrect market responses.

5.2 The FOA strongly supports the FSA's expectation that:

- (a) *"the FCA will be a risk-based regulator"* and notes that it will have a *"lower risk tolerance"* than the FSA because of major mis-selling;
- (b) all firms will be subject to a minimum level of base-line supervision in line with international standards (para 5.12), but prudential requirements should still be authentically risk-based, and recognise that small firms, firms that pose no significant risk to the financial system and substantially differentiated firms (e.g. commodity firms) should still be entitled to appropriately differentiated treatment.

For these reasons, the FOA supports the assurance by the FCA that oversight of each very differentiated regulatory firm will *"need to be tailored to reflect its own particular set of issues"* and that its approach will reflect a firm's *"business plan, risk, appetite, remuneration mechanisms and identified internal and external risks"* (but this should also include customer profiles and firms' products, services and the risk that they pose to the financial system).

5.3 With regard to the supervision of markets, the FOA supports the intention to adopt a comparable approach to that currently being exercised by the FSA in relation to the regulation of market infrastructures and the intended scope of the supervision of trading infrastructures as set out in para 5.19.

5.4 With regard to the section on policy/rule-making, the FOA generally supports the expressions of policy that will govern FCA's conduct in this area, including:

- (a) early and rigorous market analysis;
- (b) the need to promote competition;
- (c) recognition of the importance of commercial drivers;
- (d) maintenance of strong, traditional disciplines;



- (e) taking into account the principles of good regulation;
- (f) the assurance that the FCA will be *“open, listening, consultative and sensitive to the impact its conduct policy will have on the market”* (para 5.33);
- (g) HM Treasury’s assurance in its consultation Cm8083, that it will look to the FCA to strengthen the regulatory system *“by promoting the role of judgement and expertise”* (para 1.13); and
- (h) the observation by Hector Sants, Chief Executive, FSA, in his speech to the British Bankers Association on 7<sup>th</sup> March 2011, in which he stated that *“The FCA will not be a ‘no failure’ institution. Removing all risk-taking from consumers would remove individual freedom of choice and considerable benefits to society.”*

The FOA would add that the FCA should, in its approach to policy/rule-making, provide specifically for periodic rulebook reviews to avoid unnecessary rules’ duplication and delivery of the Government’s objectives of “value for money” and proportionate regulation, as referred to in para 1.3 of this response.

5.5 With regard to para 5.42 in the DP and the ability of a range of organisations to refer to the FCA products which carry potential mass consumer detriment, the FOA believes that this is a power which should be confined to credible and properly accountable groups:

- (a) bearing in mind the potential for unjustifiable reputational risk to a named firm;
- (b) to reduce the risk of reporting abuse, the submission of vexatious reports and the making of unwarranted attacks on the reputation of firms; and
- (c) to prevent the FCA being locked into a series of potentially costly, protracted and controversial procedures and processes without good cause.

The FOA would emphasise the importance of allowing any firm or group which is the subject of any such report to be given a full right of response before any public steps are taken and believes that the FCA should be under a clear obligation to take that response into full consideration in deciding what action, particularly if it is of a public nature, is to be taken.

## **6. Co-ordination**

6.1 With regard to Box 6 in the DP, the FOA believes that there should be a dotted line between the Bank of England and the FCA in relation to CCPs, bearing in mind particularly the requirement in the draft Bill that they should enter into an MOU and the fact that the vast majority of CCPs are now incorporated within FSA-regulated exchanges. This means that exchanges will be facing dual regulation in relation to the delivery of execution and clearing services and, as a consequence, the risk of duplicate, overlapping or conflicting regulation should be avoided wherever possible. The FOA believes that greater emphasis could have been placed on FCA / Bank of England co-ordination in paras 6.3-6.6 in the DP.

- 6.2 We also note that the European Securities and Markets Authority (“ESMA”) will likely develop rather granular rules that will apply to CCPs operating in EU member states. This raises the question of how the proposed UK structure for the regulation of CCPs will operate within this scheme. Care should be taken to ensure that CCPs regulated by the Bank of England are not subject to rules which place them at a competitive disadvantage relative to CCPs based in other European jurisdictions. .
- 6.3 The FOA has no particular comments in relation to the Ombudsman Service, the FCSC and the Money Advice Service, other than to express the concern of some of its members that the extent of the liability to contribute to the FSCS should be linked to the claims risk of the contributor and welcomes, therefore, the intended review of the FSCS.

**LIST OF FOA MEMBERS**

**FINANCIAL INSTITUTIONS**

ABN AMRO Clearing Bank N.V.  
 ADM Investor Services International Ltd  
 Altura Markets S.A./S.V  
 Ambrian Commodities Ltd  
 AMT Futures Limited  
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