

The UK Regulatory Environment

Although many of the concepts and practices described in this text are products of a growing Compliance discipline that does not proceed directly from any regulatory rule or guidance, regulation is undoubtedly the founding spark and ultimate justification of all Compliance activity in the financial services industry. It is almost certainly true that there would be no Compliance function, Compliance Officers or Compliance anything else if there had not first been a regulatory system in which to put them. It therefore follows that to get to grips with Compliance one should have a sound understanding of the regulatory environment that gave rise to it.

This is not to say that Compliance does not justify itself on its own terms, but no business ever volunteered for it; no one wants to be ‘fettered’ by a framework of ‘restrictions’. Financial services regulations are there because the industry has purposes to serve beyond the enrichment of those it employs directly, but has a patchy record when it comes to making itself fit for the pursuit of any other ends. Compliance is there because it is too risky and too complicated to try to navigate the regulatory terrain without it.

Therefore, while I dedicate this text to making arguments for the positives that a business can take from effective Compliance, there is no question that it began and, to a large degree, remains an agent of regulation and can only be properly understood with the regulatory regime, in the UK as elsewhere, as a starting point.

Before looking in detail at the constituent parts of the Compliance Officer’s world this chapter fills in the essential background with a brief description of the regulatory environment in the UK. Compliance Officers working in other jurisdictions should know at least as much about their own regulatory environment as that described here for the United Kingdom.

1.1 REGULATION IN THE UK

There is currently a myth in the UK that we have a single financial regulator (the FSA) and a single piece of regulatory legislation (the Financial Services and Markets Act 2000 (FSMA)). If you have bought into this story, then you need to think again. In the UK alone there are numerous regulatory bodies other than the FSA that cover financial services activities – the Pensions Regulator, for example, and the Takeover Panel. There are also a number of laws and regulatory-type bodies that govern the national anti-money laundering effort. And, looking further afield, it’s impossible to deny that overseas legislation and regulators affect financial services activity carried on within the UK. (See Box 6, ‘Going Global’ on page 326 for further explanation on this point.)

Most, but it must be stressed *not* all, of the UK regulatory framework is based on UK and EU law.

Financial services legislation in the UK

UK Law

- UK law can be divided into two main types:
 - statute law – law created through acts of parliament.
 - case law or common law – law established through legal precedent developed over hundreds of years from custom, tradition and cases coming to court.
- Statute law is of most relevance to financial services although common law also has an impact through, for example, contract law in relation to loan agreements.
- A piece of statute law cannot become final until it has been agreed by both Houses of Parliament and has subsequently received Royal Assent from the Queen.
- Acts of Parliament cannot possibly contain every single detail relating to the area they govern. Consequently, secondary or delegated legislation is used to update and amend statute law without having to go through the full legislative process. This secondary legislation, referred to as *statutory instruments* or *regulations*, has the full force of law.

The EU Dimension

- As we are members of the European Union the UK government must implement EU legislation.
- The main way in which EU law impacts UK regulation is through the implementation of the directives and regulations issued as part of the EU's Financial Services Action Plan (see Box 5 on page 324) and the Lamfalussy Process (see Box 13 on page 337).
- Directives and regulations are pieces of EU legislation that are binding on its member states¹ and on non-member states within the European Economic Area (EEA).² Directives allow national governments certain flexibility in terms of how the end result is achieved and need to be transposed into the law of each member state (further details of key financial services directives are available in Appendix 5) whereas regulations do not require such transposition and thus apply directly to individual member states without being separately implemented in each country.
- EU law is aimed at harmonizing standards across the EEA in order to support the single market objective and the relevant directives and regulations apply across the EEA in the same way that they apply to the UK, although the extent to which they have really been implemented in letter and spirit across each member state is a matter of debate.

¹ At the time of writing there are 27 EU member states: Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.

² At the time of writing these are Norway, Iceland and Liechtenstein.

Overseas Legislation

- Some pieces of legislation enacted in other jurisdictions are applied on an extraterritorial basis.
 - For the financial services industry, the main pieces of relevant legislation falling into this category come from the US – see Appendix 6.
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Sitting underneath and alongside the legislation are the requirements that stem from sets of rules, guidelines and industry best practice that underpin the law.

1.2 DIFFERENT REGULATORY REGIMES IN THE UK

It is possible to group pieces of legislation, sets of requirements, etc., together into various subject areas and thus the UK regulatory framework can be divided into various distinct areas (although there is a certain degree of overlap). These include

- the FSMA regime for investment business;
- the anti-money laundering regime; and
- the takeover regime.

The key features of these are described below.

1.3 THE FSMA REGIME FOR INVESTMENT BUSINESS

The Financial Services and Markets Act 2000 (FSMA) came into effect on 30 November 2001, a date also referred to as N2 (more detailed guidance about the contents of FSMA is set out in Appendix 3). Under FSMA, the FSA (see Appendix 1) was established as the UK's regulator for a large proportion of financial services activity (see below), replacing the nine existing regulators that were previously responsible for supervising the UK's financial markets.

What does the FSA regulate?

FSMA and FSA requirements apply to 'specified activities' that are undertaken in relation to 'specified investments' (as defined by the Regulated Activities Order (RAO) – see Appendix 1) made under FSMA.

Examples of specified activities

- Dealing
 - Managing investments
 - Safeguarding and administering investments
 - Establishing a collective investment scheme.
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Examples of Specified Investments

- Shares
- Bonds
- Futures
- Options
- Contracts for differences
- Units in collective investment schemes.

The term 'investment business' is commonly used to refer to the carrying out of specified activities in relation to specified investments.

Examples of Activities and Financial Instruments not Specified by the FSA

- Arranging credit
- Cash
- Premium bonds
- Spot FX
- Commodity derivative transactions undertaken for commercial rather than investment purposes
- Letters of credit
- Bills of exchange
- Promissory notes.

There is a further distinction between designated and non-designated investment business (see table on page 8).

Of course the above is summary information only. Full information is available in the RAO, which is an extremely useful document when determining what is and is not subject to FSA rules. This is not always clear cut, and there can be a few surprises. I will never forget the look of total astonishment on an overseas colleague's face when I told her that the FSA regulated funeral plans. We should not, get carried away in terms of the FSA's extensive reach though, as one of my non-Compliance friends did. She announced to me, perplexed that the FSA seemed to be involved in all sorts of things that you would not have expected – like milk production! My friend was thinking of the *other* FSA – the Food Standards Agency!

The merging of the regulators was implemented in order to reflect the fact that there is no longer a clear enough distinction between different types of firm to merit different types of regulator – banks are also providing stockbroking services, etc. Additionally, there was a degree of overlap in the responsibilities of some regulators, whereas other activities risked falling between two supervision regimes or not being reviewed at all; and there was always the possibility that inadequate information-sharing between regulators would contribute to a financial failing. Finally, there was a perception that the previous regime had not been a success (in part because it did give rise to some of the above weaknesses) and there was a desire to draw a line under past failures in order to start afresh.

The FSA is responsible to the Treasury and must also account to a consumer panel and a practitioner panel on the extent to which it is meeting the regulatory objectives that have been set out for it in FSMA. The FSA has translated requirements from FSMA and various EU laws

into a comprehensive handbook of rules and guidance covering a wide range of topics including

- listings;
- conduct of business;
- enforcement;
- collective investment;
- financial resources; and
- senior management controls.

Both FSMA and the FSA Handbook must be amended on an ongoing basis to take account of new requirements stemming from EU law. The key EU legislative initiatives that are of relevance to financial services are the Financial Services Action Plan (see Box 5 on page 324) and the Lamfalussy Process (see Box 13 on page 337). The piece of EU legislation that has the greatest impact on the FSA Handbook is probably the Markets in Financial Instruments Directive (MiFID) (see Appendix 5 and Box 9 on page 331), so it is unfortunate that its scope does not entirely tally with that of the FSA/FSMA and gives rise to a situation in which different rules apply, dependent on whether an activity is regulated only under FSMA, or is also covered by MiFID. The table on page 8 gives further details on this.

Some of the other key elements of the FSMA regime are described below.

- The FSA must comply with the four statutory objectives imposed on it under FSMA (see Appendix 3).
- It is an offence to conduct a regulated activity in the UK unless you are authorized under FSMA or exempt from its requirements. This is known as ‘the General Prohibition’.
- There are various ways of gaining authorization:
 - obtaining permission to carry out regulated activities under part IV of FSMA;
 - exercising passporting rights under a relevant EU directive (EEA Passport rights); or
 - exercising rights under the Treaty of Rome (Treaty rights).
- There are various categories of person subject to regulation:
 - regulated firms;
 - individuals working for regulated firms;
 - recognized professional bodies;
 - exchanges and clearing houses; and
 - collective investment schemes.
- Although FSMA requirements have been translated into the FSA’s Handbook of Rules and Guidance, the FSA is now adopting a much more principles-based approach to regulation and the industry has yet to decide whether this is a good thing or not – see Box 1 on page 317 (‘Acting on Principle’).
- Although all business specified in the RAO is subject to FSA regulation, the FSA has further ‘designated’ certain types of investments and investment business to which it applies particular sets of rules, such as those in the Training and Competence and Conduct of Business Sourcebooks. Further detail is available in the table on page 8.
- The FSA is the competent authority for UK stock exchange listings.
- The FSA does not directly regulate takeovers and mergers, although it does endorse the Takeover Code and imposes a number of requirements that are relevant in such situations.

The FSA is often heavily criticized both by the Compliance fraternity and by our colleagues in other areas of finance, but much as it can be cathartic after a long day in the office to denigrate the regulator, there is also much to be said for giving credit where credit is due. Compared with a number of comparable overseas regulatory bodies, believe me, the FSA is not that bad. Some of its plus points are that it

- has a transparent and active enforcement process;
- consults widely on new requirements and has even been known to take account of the responses to these consultations when formulating new regulation;
- provides substantial guidance on its rules;
- has a comprehensive website for regulated firms;
- offers important consumer guidance in the form of brochures and leaflets, as well as via the dedicated sections of its website – Money Made Clear;
- has clear statutory and regulatory objectives which provide a valuable yardstick for assessing its performance and setting its priorities;
- cooperates with many other regulators in the UK and internationally, and does its best to protect us from the worst excesses of the EU regulatory machine;
- does not change its rules on a whim, and on an almost daily basis, as some regulators are wont to do;
- is manifestly accountable in its activities through a number of mechanisms including
 - the office of fair trading (which can scrutinize FSA rules and practices);
 - the financial services and Markets Tribunal;
 - the consumer panel;
 - the practitioner panel; and
 - the complaints commissioner.

And, in any case, London continues as a major financial centre with no prospect on the horizon of that changing. It would seem churlish to refuse the FSA at least some small part of the credit for establishing and maintaining a regulatory environment in which firms are happy to do business.

Types of business under FSMA/MiFID

Type	Source	Explanation
Investment services and activities	The FSA and MiFID	Services relating to financial instruments, including <ul style="list-style-type: none">• executing client orders;• operating an MTF;• portfolio management;• dealing on own account;• making a personal recommendation.

Financial instrument	The FSA and MiFID	<ul style="list-style-type: none"> • Transferable securities, e.g. shares and bonds. • Money market instruments, e.g. treasury bills, certificates of deposit and commercial paper. • Units in collective investment undertakings. • Futures, options, swaps and forward rate agreements on a number of instruments including <ul style="list-style-type: none"> – securities; – currencies; – interest rates; – financial indices; – commodities that can be physically settled as long as they are traded on a regulated market and/or an MTF; – climatic variables; – freight rates; – telecommunications bandwidth.
Specified investment	RAO	Specified investments are those which have been listed as such in Part III of RAO, and to which FSMA requirements apply.
Specified activity	RAO	Specified activities are those which have been listed as such in Part II of RAO, and to which FSMA requirements apply.
Designated investment	The FSA	<ul style="list-style-type: none"> • Designated investments are a subset of specified investments to which detailed FSA requirements apply, such as those in COBS and TC. • Examples of investments ‘Specified’ under RAO but not ‘Designated’ by the FSA include Lloyd’s syndicate membership, rights under a funeral plan contract, deposits and electronic money, and certain mortgage contracts. • A number of designated investments are not defined as ‘financial instruments’ under MiFID.
Designated investment business	The FSA	<ul style="list-style-type: none"> • Includes the following, where they are carried on by way of business: <ul style="list-style-type: none"> – dealing in investments as principal; – dealing in investments as agent; – arranging deals in designated investments; – managing designated investments; – operating an MTF; – safeguarding and administering designated investments;

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Type	Source	Explanation
MiFID business	MiFID and the FSA	<ul style="list-style-type: none"> – safeguarding and administering designated investments; – establishing, operating or winding up a collective investment scheme; – providing advice on designated investments; • Certain FSA rules (such as those in TC) are applicable to designated investment business whereas they do not apply to other activities. • Examples of investment activities ‘specified’ under RAO but not ‘designated’ by the FSA include accepting deposits, advising on Lloyd’s syndicate participation and mortgage lending.
Non-MiFID business		<p>Investment services and activities, and where relevant ancillary services, carried on by a MiFID investment firm.</p> <p>Designated investment business that is not within the MiFID definition of investment services and activities. Examples include</p> <ul style="list-style-type: none"> • Lloyd’s business; • some investment research; • sports and leisure spread betting; • operators of collective investment schemes; • provision of insurance; • managers of investment trusts; and • provision of occupational pension scheme services, such as fund management.
Ancillary services	MiFID and the FSA	<p>Includes</p> <ul style="list-style-type: none"> • safekeeping and administration of financial instruments belonging to clients; • corporate finance advice; • providing margin trading services; • investment research; • underwriting services.
MiFID investment firm	MiFID and the FSA	<p>An investment firm, or credit institution providing investment services, to which MiFID applies, and a firm providing services under Article 5(3) of UCITS (see Appendix 5).</p>

Equivalent business of a third country investment firm	MiFID and the FSA	The business of an investment firm operating in the UK but based in a non-EEA state, that would be MiFID business if the firm were a MiFID investment firm.
Common platform firm	The FSA	A firm to which both MiFID and CRD (the Capital Requirements Directive) apply.

1.4 THE UK'S ANTI-MONEY LAUNDERING REGIME

Money laundering is the process by which criminals hide the illicit origins of their cash or other assets (see Box 14 on page 339, 'The Laundering Process') and integrate them into the legitimate financial system. The term was traditionally used in relation to the spoils of drug trafficking but it now covers the proceeds of any sort of criminal activity, from petty crime and 'minor' tax fiddles to full-scale organized crime such as people smuggling and VAT fraud.

Another major area that comes under the banner of money laundering is terrorist financing which takes place when terrorists use the financial markets to

- carry on otherwise legitimate businesses of which the profits will be used to promote terrorism;
- finance bogus charities used to promote terrorist beliefs and causes;
- buy arms; and
- fund terrorist action.

Given the massive scale of the problem (some statistics are provided on page 333) how realistic is it to believe that not a single dirty dollar has ever passed through your firm? It is no wonder that one of the FSA's four statutory objectives is to reduce financial crime and that a range of other regulatory organizations also make this a priority. At the very highest level, the approach to anti-money laundering and counter-terrorist financing controls is set by the United Nations, which is behind a number of international conventions in this area, such as the 1988 Vienna Convention Against Drug Trafficking and the UN Convention for the Suppression of Terrorist Financing. The EU has also been an enthusiastic legislator against money laundering with its latest major initiative being the Third Money Laundering Directive (see Appendix 5).

Based to a large extent on the above, the UK has implemented its own anti-money laundering and counter-terrorist financing legislation and, in addition, we have a copious amount of industry guidance, some of which is voluntary, such as that from the Basel Committee of Banking Supervision, and some of which has quasi-regulatory status. The most significant entry in the latter category is the JMLSG Guidance Notes (see Appendix 1). These notes provide comprehensive 'guidance' on two levels:

- The internal anti-money laundering infrastructure that financial services firms should implement (staff training, identifying and reporting suspicions of money laundering etc).
- The actual 'know your customer/KYC' vetting that firms should carry out in respect of particular types of customer and transaction (see Appendix B for further information).

Although the JMLSG Guidance Notes are just what they say on the box – *guidance* – you would be rather foolish to ignore them without a good reason. This is because the FSA has stated very clearly that it regards observance of the JMLSG Guidance Notes as an indicator that a firm complies with the FSA’s anti-money laundering requirements, and non-observance as an indicator of the opposite.³ You should also be aware that the anti-money laundering requirements apply much more broadly than the FSMA regime, so you must comply with requirements in this area whether or not you are undertaking investment business as defined by the FSA. (Indeed, legislation also applies to a number of other sectors, including casinos, estate agents and dealers in high-value items.)

With the weight of this heavy legislative regime hanging over us if we get things wrong, Compliance Officers can truly be classed as the government’s unpaid foot soldiers in the fight against global crime and terrorism, leading some to complain that if they had wanted to work in law enforcement they would have chosen a different career. They argue that, given the importance of controls in this area, it is not appropriate for so much responsibility to be placed on the private sector, which has at least a short-term vested interest in not identifying any money laundering at all.

Think of the massive costs incurred by firms implementing anti-money laundering regimes of the type envisaged by today’s regulations – it is similar to being charged a tax for the privilege of being able to help the government to catch criminals, and we have to question just how effective the controls we are being asked to implement really are: for instance, it is hard to believe that an international syndicate of criminals who have almost unlimited funds and resources at their disposal will allow themselves to be tripped up by not being able to produce a phone bill. Indeed such is the sophistication of these organizations that they will probably employ lawyers who know the KYC rules as well as the firm itself, and will present themselves with a pristine set of KYC documents with which no fault can be found.

And despite the fact that we make all this effort and try to get things right we cannot even guarantee that this is enough: consider the case of Mr Judge for example, the poor MLRO who did everything by the book but still found himself being taken to court.

Regardless of the criticisms of the regime, however, the authorities argue that it is logical for financial services firms to take the lead in identifying suspicious activity as they know their customers and their normal patterns of activity, whereas the police do not. This, admittedly, is true and it does not look like we will be relieved of our front line duties in this area anytime soon.

1.5 THE UK’S TAKEOVER REGIME

UK takeovers and mergers are regulated by the Panel on Takeovers and Mergers (see Appendix 1) which was established in 1968. Its key requirements are set out in the City Code on Takeovers and Mergers (‘the Takeover Code’). Although the Code is not a piece of legislation, statutory weight is lent to the regime by means of

- the Companies Act 2006, part 28;
- the EU Takeover Directive; and
- endorsement by the FSA.

³ See *The FSA Handbook* – SYSC 3.2.6E.

Even though the Takeover Panel is entirely separate from the FSA, the two regulators collaborate where necessary, especially in relation to market abuse, which is one of the main areas where there is likely to be an overlap in respect of their fields of responsibility.

Competition is another matter that must be considered at the time of a takeover or merger, and this area is governed by the Enterprise Act 2002 and a number of authorities including

- the Competition Commission;
- the Office of Fair Trading;
- the Competition Appeal Tribunal; and
- the EU's Directorate General for Competition.

1.6 OTHER UK REGULATORY REGIMES

In addition to the three regimes summarized above, other regulatory frameworks are in place for different aspects of the UK financial services industry, including those relating to

- consumer credit and hire purchase;
- personal and business banking; and
- company pensions.

