**Introduction to the City**

In this element we will look at the different financial markets and their functions, the key players operating in those markets and the role of regulators.

**What is “the City”?**

“The City” is a generic term that is often used to refer to London’s financial services industries; they have historically been based in the City of London.

The City of London is quite a small area of London, sometimes referred to as the 'Square Mile'. The City spans from Holborn (in the West) to Aldgate East, and from the Barbican and Old Street (in the North) to the River Thames (in the South). It has its own governing body (the City of London Corporation) and its own police force (the City of London Police).

​Many banking and insurance institutions still have headquarters or a significant physical presence within the City’s boundaries. The London Stock Exchange, Lloyd’s of London (insurance) and the Bank of England are all based in the City. Financial market players are now more widely spread; many institutional investors (such as hedge funds and private equity firms) congregate in London’s West End (around Knightsbridge, Mayfair and St James’s). Many of the large investment banks have, meanwhile, moved east (towards Canary Wharf).

**What is the position of the City in the UK and the global economy?**

While we still often refer to the financial services industry in London as “the City”, London’s financial services industry exists to service the financial markets both throughout the UK and internationally.​

Although the City is geographically small, it occupies a key position in the UK economy. It also occupies a leading position in the global economy. London ranks as number two (second only to New York) in the Global Financial Centres Index (the GFCI) for 2024. This index is produced by the China Development Institute and Z/Yen Partners. It seeks to measure the comparative competitiveness of the world’s leading financial centres. The GFCI takes into account a wide range of factors. These include:​

· Financial development factors (e.g. volume and value of trading in each financial centre) ​

· Business environment factors (e.g. regulatory, legal and tax structures that apply) ​

· Human capital factors (e.g. availability of a skilled and international workforce) ​

London scores highly on all of these factors.

**Context: Solicitors advising in the City**

For a City solicitor advising clients based in or operating with the City, it is vital to understand the commercial underpinnings of the City. In other words:​

· Who is buying and selling? ​

· What is being bought and sold? ​

· Why?​

· How?​

This element is designed to help lay the foundations for this understanding.

We will consider:

· Different markets and their functions

· Who are the key players operating in those markets

· How is the City regulated

**Overview of different markets​**

A fundamental economic concept is that there are:​

those who need money (or capital) to spend, and ​

those who have money (or capital) and want to invest it in order to make a return. ​

Individuals and corporations have many and diverse interests. Different markets service different needs, bringing together willing buyers and sellers. Those operating in the different markets might be looking for specific goods or services or they might be looking to investment money in exchange for a future or ongoing return on their investment. ​

Between buyers and sellers are intermediaries, facilitating introductions and brokering deals.

**Overview of key functions of the financial markets​**

Markets ultimately exist to bring together those who want to buy with those who want to sell.​

For example: On one side, a company may need money to finance the redevelopment of a property it owns. On the other side, a pension fund may have funds available and on which it would like to obtain a return. If these two parties are brought together (for example, by an intermediary), the pension fund may lend money to the company to fund its redevelopment. Alternatively, it may provide the required capital in some other form instead (for example, by investing in shares in the ownership of the company).

**Functions of the financial markets​**

Financial markets serve a number of separate but connected purposes:

· Provision of a marketplace

· Mechanisms to determine appropriate pricing

· Hedging of risks

**Function: provision of a marketplace**

The first and principal function of the financial markets is to provide a market - a market facilitating the supply of money/capital from those who have it to those who need it. ​

Let us look at an example:​in its simplest form, the holder of a HSBC current account in credit is in fact lending money to HSBC. The bank is an example of a financial intermediary. Having borrowed the money from account holders in credit, HSBC then lends that money to individual borrowers (for example, through mortgages, car leases, credit cards or consumer loans) or to commercial borrowers. ​

The ‘price’ at which money changes hands in this example is the interest rate paid by HSBC on the current account compared to the interest rate payable (by a borrower) on the onward loans given by HSBC.

**Function: a mechanism to determine pricing ​**

The second function of the financial markets is to provide a mechanism for determining the appropriate pricing for transactions between: (1) buyers and sellers; (2) lenders and borrowers; and (3) investors and investees. ​

The price at which money/capital is supplied will respond to market forces (which will of course change over time). It is clear, for example, that if money/capital is in short supply, lenders will be able to charge more for their investment. If money/capital is plentiful, meanwhile, then lending rates will go down. ​

This potential volatility in pricing can be a risk for participants in the market.

**Function: hedging of risks​**

The third function of financial markets is to allow market participants to ‘hedge’ these kind of risks and to protect themselves against financial risks.​

Here is an example of ‘hedging’ by a bank offering fixed-rate mortgages: ​

A mortgage borrower may wish to fix their interest rate for a period of five years in order to protect themselves against interest rates rising. The borrower would therefore obtain a fixed-rate mortgage from a bank. In turn, the bank might ‘hedge’ their risk of offering a fixed interest rate by taking out an ‘interest rate swap’ with another financial institution (a counter-party). Under such a swap arrangement, if interest rates rose, the counter-party would pay the bank on a floating rate basis, in return for receiving the fixed rate agreed with the original mortgage borrower.

**Overview of key City financial markets**

Within the City, there are a number of different markets that exist to facilitate different types of investments. These include investments in companies (shares); debt investments (such as loans or bonds); derivative instruments (such as interest rate swaps, where a fixed rate might be exchanged for a floating rate); interests in currency; interests in insurance; interests in shipping; and interests in commodities.

Key markets are:

· Stock exchanges

· The currency market

· Money markets

· Insurance market: Lloyd’s

· The Baltic Exchange

· The London Metal Market

· Other exchanges

More detail on each of these key markets is contained in your optional consolidation reading material.

**Overview of key players**

Examples of parties who might need access to additional money include governments and companies. ​

Examples of parties with money to invest include pension funds, sovereign wealth funds (funds owned by cash-rich states) and private equity funds (generally designed to facilitate collective investment schemes). ​

Between these two sides sit the intermediaries. These include the professionals who facilitate the markets, including banks and fund managers; as well as operators of the markets, such as the London Stock Exchange; and regulators who ensure that the markets operate smoothly and fairly.​

Overview of the investments​

In deciding on the form of investment to be made in each case, the parties will consider a range of factors. These might include: ​

· how much money is required; ​

· how long or short a period the money is needed for; ​

· how risky the investment may be (and therefore how high a return is needed to make it worthwhile for investors); ​

· how many investors are interested in the opportunity; and ​

· the motivations of both the existing and new investors.

**How is the City regulated?**

We can see from the array of financial markets operating in the City that there is a vast amount of money passing between the participants in these markets – and where there is money, there will generally be some system of regulation to protect the counterparties involved. ​

Some of the markets discussed above are effectively closed to all but large and sophisticated investors, who understand the risk they are running by trading; some are effectively available to all, including ordinary retail investors (individual people) who may not have any financial expertise at all. ​

Regulation tends to be strongest where the regulators consider that it is needed to protect the retail investor: the view is often that institutional and other sophisticated investors can look after themselves.

The key regulatory bodies that we are going to consider in the context of the financial markets in the City are those involved in regulating both the markets themselves and also the intermediaries who operate in those markets. In particular, we will first look at the three bodies that share overall regulation of the financial system in the UK:​

· The Financial Policy Committee (“FPC”) of the Bank of England – which is responsible for the stability of the financial system as a whole (known as “macro-prudential regulation”);​

· The Prudential Regulation Authority (“PRA”) – which is responsible for the financial soundness of significant intermediaries operating within the system (known as “micro-prudential regulation”); and​

· The Financial Conduct Authority (“FCA”) – which regulates the conduct of authorised intermediaries within the system (referred to as “conduct of business”).

**Role of the Bank of England and the Financial Policy Committee**

The Bank of England is the UK’s central bank. Its mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. ​

As part of this overall objective, it carries out a regulatory role in relation to the UK financial system through one of its committees - the Financial Policy Committee (FPC). The FPC is responsible for identifying, monitoring and taking action against any systemic risks, in order to protect and enhance the resilience of the UK’s financial system. The Committee has a secondary objective to support the economic policy of the Government.​

As a committee of the Bank of England, the FPC is made up of senior members of the bank together with external academics and experts. It can make recommendations and give directions to the PRA but is not directly involved in the day-to-day supervision of individual firms.

**Role of the Prudential Regulation Authority ​**

The Prudential Regulation Authority (PRA) is a subsidiary of the Bank of England. It reports to the FPC and is responsible for the supervision of around 1,500 banks, building societies, credit unions, insurers and major investment firms.​

The PRA requires the financial firms that it supervises to maintain sufficient capital and have adequate risk controls in place. These requirements are set out in the PRA Rulebook. Close supervision of these firms by the PRA ensures that it can step in if any firm is not being run in a “safe and sound” way or, in the case of insurers, if they are not protecting policyholders adequately. ​

The PRA also issues statements of policy, detailing their policy on particular matters, and supervisory statements, setting out their expectations for how the firms they supervise will meet their regulatory obligations. This emphasises the PRA’s approach to supervision, which is that judgement is more important than adherence to the letter of the law, and that it would rather address emerging risks before they crystallise than have to impose disciplinary measures after the event.

**Role of the Financial Conduct Authority​**

The Financial Conduct Authority (FCA) is an independent public body funded by the firms it regulates. It has a strategic objective to ensure that the UK financial markets function well: its operational objectives are to protect consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers. In carrying out its objectives, it has a very wide remit. Its work is scrutinised by the Treasury Select Committee of the House of Commons.​

In terms of the roles it plays within the regulatory system, the FCA is firstly responsible for “conduct of business” supervision of all financial firms (approximately 56,000 of them), as well as for the prudential supervision of all non-PRA firms (approximately 24,000 of them). This gives the FCA the power to regulate conduct relating to the marketing of financial products.​

Secondly, it supervises trading and market infrastructure and is the ‘competent authority’ for listing and prospectuses. In this connection, it is responsible for reviewing each company seeking a listing on the Official List of the London Stock Exchange and approving each published prospectus (i.e. the regulatory document issued in connection with a listing). It also has responsibility for writing and enforcing the Listing Rules.​

Thirdly, the FCA has power to investigate and prosecute the criminal offence of insider dealing and can impose civil penalties for market abuse. It also oversees the Financial Ombudsman Service, the Money Advice Service and (jointly with the PRA) the Financial Services Compensation Scheme.

**Role of the Takeover Panel**​

In addition to the three regulatory bodies summarised above, which share the task of ensuring the health of the UK financial markets, the other key City regulator is the Takeover Panel. The Takeover Panel is a statutory body that administers the Code on Takeovers and Mergers (the ‘Takeover Code’), which effectively sets out rules that govern the acquisition of listed UK companies. ​

Given the spread of shareholders that own listed companies – most of them holding only a small percentage of shares – it would be easy for a predator investor to gain control of a listed company by acquiring shares in the market, without paying a premium to the other shareholders for that control. The principles and rules set out in the Takeover Code are designed to ensure that this cannot happen, and that on a takeover of a listed company, all shareholders are treated equally. They achieve this through provisions governing disclosure, timing, pricing and conditionality of any offer for a listed company – and they require a regulated offer to be made to all shareholders on a mandatory basis whenever an investor acquires 30% or more of the shares in a listed company.

The Panel operates through its Executive, which is staffed by a mixture of employees and secondees from law firms, accountancy firms, corporate brokers, investment banks and other organisations. The Takeover Panel and its Executive takes the approach that it is vital for market participants to follow the spirit of the Takeover Code as well as the letter. ​

Summary

· The City occupies a key position in the UK and global economy​

· Different financial markets service different needs, bringing together willing buyers and sellers​

· Financial markets have three key functions: to provide a marketplace, as a mechanism to determine appropriate pricing, and to hedge risk​

· Key players in the markets are those who need to access funds, those who want to invest funds and intermediaries​

· The City is regulated by a number of key regulatory bodies